GAO STUDY OF MILITARY SEALIFT COMMAND

HEARING

BEFORE THE

SUBCOMMITTEE ON MERCHANT MARINE

OF THE

COMMITTEE ON MERCHANT MARINE AND FISHERIES HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON THE GENERAL ACCOUNTING OFFICE STUDY OF MILITARY SEALIFT COMMAND POLICIES AND PROCEDURES AS THEY AFFECT THE U.S. MERCHANT MARINE

AUGUST 9, 1988

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GAO STUDY OF MILITARY SEALIFT COMMAND

TUESDAY, AUGUST 9, 1988

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MERCHANT MARINE,
COMMITTEE ON MERCHANT MARINE AND FISHERIES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:06 a.m., in room 1334, Longworth House Office Building, Hon. Walter B. Jones (Chairman of the Subcommittee) presiding.

Present: Representatives Jones, Anderson, Hubbard, Foglietta, Hertel, Lipinski, Borski, Tallon, Bennett, Pickett, Brennan, Hochbrueckner, Bonker, Dyson, Sweeney, Lent, Davis (Ex Officio), Young, Shumway, Fields, Bateman, Saxton, Miller, Bentley, and Coble.

Staff present: Cynthia M. Wilkinson, Chief Counsel; Melanie M. Barber, Counsel; Gregory L. Lambert, Counsel; Rudolph V. Cassani, Counsel; Ann M. Mueller, Clerk; Kip Robinson, Minority Counsel; Ed Welch, Chief Counsel; Gerry Seifert, General Counsel for Maritime Affairs; John Cullather, Staff Assistant; Mark Aspinwall, Staff Assistant; George Pence, Minority Staff Director; Duncan Smith, Chief Minority Counsel; K. C. Bell, Minority Special Assistant; Rusty Johnston, Minority Counsel; and Gwen Lockhart, Chief Minority Clerk.

STATEMENT OF HON. WALTER B. JONES, A U.S. REPRESENTATIVE FROM NORTH CAROLINA AND CHAIRMAN, SUBCOMMITTEE ON MERCHANT MARINE

Mr. JONES. The Subcommittee will come to order please.

Today, the Subcommittee on Merchant Marine holds an oversight hearing on how Military Sealift Command (MSC) policies and procedures affect the U.S. merchant marine.

Back in January, the Honorable Mario Biaggi asked the General Accounting Office to conduct a study of this issue, and GAO will be presenting its findings this morning.

After reviewing a number of areas, GAO narrowed its report down to three main topics: the use of A–76 cost comparisons for the operation and maintenance of MSC ships; the bidding system currently employed to award military cargo contracts; and the use of the Ready Reserve Force (RRF) ships.

Commercial operators argue that MSC policies are killing the merchant marine. They say that it is almost impossible for operators to beat the Government's cost in an A–76 cost comparison. Some operators complain that competition for military cargo is so intense that they are submitting noncompensatory bids and, in es-

sence, paying the Government for the privilege of carrying Government cargo.

The MSC says it appreciates the importance of the merchant marine to the national defense and highlights the fact that billions of dollars are spent for maritime services each year. MSC says, however, that it is obligated to spend the Government's money in the most cost-effective manner.

They may both be right. What we have here is a classic case of the Federal Government torn between two mandates: saving money and fostering the development of our merchant marine. It will be this Subcommittee's job to study this report very carefully and determine what we can do to remedy the situation and reconcile these differences.

Our first witness is Mr. Bill W. Thurman, Deputy Director of the National Security and International Affairs Division of the General Accounting Office. He is accompanied by Mr. John Landicho and Mr. Joseph P. Walsh.

Gentlemen, please come around.

Mr. Thurman, you may proceed.

STATEMENT OF BILL W. THURMAN, DEPUTY DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN LANDICHO, SENIOR ASSOCIATE DIRECTOR, NSIAD/NAVY-MARINE SUBDIVISION; AND JOSEPH P. WALSH, EVALUATOR-IN-CHARGE

Mr. THURMAN. Good morning, Mr. Chairman. Thank you very much.

We are very pleased to be with you this morning to report on the results of the inquiry that we are conducting at the request of this Subcommittee into policies and procedures used by the Military Sealift Command and the concerns that have been voiced by members of the U.S. merchant marine regarding the impact of these policies and procedures on the merchant marine.

What I have this morning, Mr. Chairman, is a fairly brief synopsis of a much longer attachment to my statement, and what I would propose to do is just go through the synopsis with you and then perhaps answer any questions, if that would be acceptable. It should take about ten minutes or so for me to get through the summary.

As you indicated in your opening statement, we, after working with the merchant marine industry, identified three primary concerns that the industry had with the Military Sealift Command's policy.

The first of these areas was the use of cost comparisons in the A-76 process to determine who should operate or maintain MSC ships.

The second concern was with the system that is used for setting cargo rates for MSC cargo.

And the third concern involved the use of the Ready Reserve Force ships, which are under the management of the Maritime Administration.

On the first point, in an attempt to operate its ships at the least cost to the Government, the Military Sealift Command since 1982

has completed five cost comparisons under the provisions of OMB Circular A-76 to determine if commercial firms or its own Civil Service mariners would provide the most economical operation and maintenance for a total of 27 Military Sealift Command ships.

Four of these five comparisons favored MSC operation of the ships, and one favored the commercial sector. For the decision favoring the commercial firm, there was a difference of about $24.8 million between the low commercial offer and MSC's cost for the operation and maintenance of 12 oceanographic ships.

On the other hand, the four decisions favoring MSC showed in total a difference of about $65.2 million between MSC's cost and the low commercial offerers' cost for operating and maintaining tankers, hospital, cable, and range instrumentation ships—a total of 15 ships.

The intent of OMB Circular A-76 is to provide the Government with commercial-type services at the lowest cost. The provisions of the circular require that a cost comparison be made between the lowest contractor's offer and the estimated cost if the Government performed the service.

Some of the commercial firms that we spoke with during the course of our inquiry believe that the operation and maintenance of MSC ships should be performed exclusively by the commercial sector.

Also, some of the commercial representatives believe that certain provisions of OMB Circular A-76 inherently favor the Government in its cost-estimating procedures.

For instance, they cite the fact that, in determining overhead costs for purposes of calculating the Government cost, the Government need only include the cost associated with the direct supervisory positions one level higher than the activity that will be carrying out the particular function, and that only those administrative support positions that would be totally eliminated if the function were contracted out need to be taken into account.

MSC, on the other hand, believes that, since most of the ships in question have previously been operated by it, the OMB Circular A-76 process and comparisons actually afford commercial firms and non-government mariners opportunities that formerly did not exist.

Additionally, MSC notes that the size of the merchant mariner workforce is not necessarily affected by the outcome of A-76 comparisons since both MSC and the commercial sector draw from the same pool of skilled mariners to carry out these functions.

Our examination of the cost comparison favoring the commercial firm shows that the biggest single difference was the size of the crew. The commercial offeror proposed to operate each ship with a smaller crew than MSC. Although MSC's Civil Service wage rates were lower, they were not low enough to offset the difference in the manning. MSC officials told us that in preparing this proposal they had mis-estimated the crew size.

In the four cost comparisons which favored MSC, we found that the largest difference was in crew cost, resulting primarily from higher wages and benefits in the private sector.

Other items also contributed to the differences, such as the high cost of insurance that the private sector has to pay and some other items.

Commercial representatives believe that certain provisions of the circular favor the Government. While they believe that, we found that the difference in crew costs are so large that merely changing some of these other provisions (such as insurance, profit, and overhead items) would not generally offset the difference in personnel costs.

In fact, our overall conclusion after looking at the studies that have been conducted to date was that it appears that increasing the number of Government-owned vessels operated by commercial firms would likely result in additional cost to the Government.

Turning briefly to the question of cargo and the rate-setting process, many members of the merchant marine industry are concerned that the current system of cargo rates used in MSC shipping agreements is driving rates too low and carriers are not recovering their costs, with obvious adverse impacts on that industry.

They stated that the competition among U.S.-flag ocean carriers for DOD export cargo, which is a major portion of the export cargo available to them, is intense. The intensity of the competition is attributed primarily to the overcapacity of cargo space presently existing among U.S.-flag carriers.

A number of modifications in the way MSC sets cargo rates have been suggested by members of the maritime industry. Basically, such changes would modify the rate-setting process, assign cargo to experienced carriers who own their own ships, allocate cargo to more carriers, and reduce the percentage of cargo allocated to the lowest bidder.

The proposals are basically intended to aid the U.S.-flag carriers. MSC believes that the rates it is paying are compensatory to the carriers and that the current practices are working reasonably well.

MSC also advised us that its practices, in its view, assure a reasonable cost to the Government, and it sees no compelling reason at this juncture to change them.

The third item that was identified to us by industry has to do with the use made of the Ready Reserve Force ships. This force is a quick response, Government-owned merchant ship reserve fleet maintained by the Maritime Administration for use by the Navy in the event of a mobilization or national emergency to transport military cargo.

Ships from the RRF are periodically activated for MSC and used to transport containerized roll-on/roll-off, or break bulk cargo in support of military exercises. Some ocean carriers contend that RRF ships are being used in multiple military exercises for what they believe is too long a period of time—generally, their definition is around 60 days—and that such extended use is taking opportunities to carry cargo away from the U.S.-flag merchant fleet.

They also believe that RRF ships, after being activated, were idle for long periods of time awaiting Government retrograde cargo or cargo for the next military exercise. MSC acknowledges that Ready Reserve Force ships have been used for increasingly longer periods than in the past, and participated in sequential exercises in an effort to save activation costs.

Beginning in the Fall of 1987, MSC began concerted efforts to carry cargo for military exercises in commercial ships whenever

possible. Our work disclosed that from October 1, 1987 through July 15, 1988, six RRF ships had been activated, and only one of those was operational for longer than 60 days. This indicates that the MSC is addressing the concerns that have been raised by the carriers.

In summary, Mr. Chairman, I think we would probably echo what you said in your opening statement. Our overall observations are that the Military Sealift Command's method of contracting for ship operation and maintenance and cargo rate-setting focused fairly heavily on obtaining the least cost to the Government, which is basically consistent with Government procurement policy.

If changes are to be made in order to provide additional support and assistance to the maritime industry, we believe that it is important that the cost associated with such changes be clearly identified so that the Congress and the Executive Branch can be in a position to see those costs and trade them off against the benefits that might be associated with changing the present practices.

That is a synopsis of the much more detailed appendix that is attached to my statement. I would be pleased to respond to any questions that the Subcommittee might have, sir.

[The prepared statement of Mr. Thurman can be found at the end of hearing.]

Mr. JONES. Thank you, Mr. Thurman.

Do the two gentlemen accompanying you want to be heard?

Mr. THURMAN. Not at this point.

Mr. JONES. Fine.

Mr. Thurman, did you consult fully with MSC while preparing your report? In other words, are its positions represented therein?

Mr. THURMAN. Yes, sir. What we attempted to do, Mr. Chairman, as faithfully as we possibly could, was to obtain the views of the maritime industry and the views of the Military Sealift Command. Our objective was to lay out as fully as possible for the Subcommittee the respective positions of both parties, and MSC was consulted extensively throughout the course of our work.

Mr. JONES. Assuming Congress decided to aid the U.S. merchant marine industry, what do you believe should be the guiding principles?

Mr. THURMAN. That is a very, very excellent question, Mr. Chairman. Let me start by addressing it this way: I think, number one—and we've discussed this at length as we have conducted this assignment—is to make a decision on exactly what we are trying to accomplish through the assistance.

The Commission on Merchant Marine and Defense, in my view, lays out a very powerful argument for the importance of the merchant marine fleet and for a viable merchant marine fleet to the defense of this country.

If the Congress concludes that, indeed, these are the principal driving factors, one of the objectives we probably should attempt to work toward—and the Commission's report contains some of these recommendations—is identifying those ships that are most useful to the military in the event of a contingency and perhaps designing programs which would promote the acquisition and operation of those types of ships.

A second principle I think that we would offer up for consideration is that if, in fact, the defense requirements become the driving force behind a decision to change present practices, it might be important to develop an approach which would permit the cost associated with the support of the maritime industry to be evaluated against other Defense Department programs and objectives.

Those are basically our observations on that particular score.

Joe or John, do you care to add to those observations?

Mr. LANDICHO. Maybe a little elaboration. In addition to identification, as Mr. Thurman pointed out, of the types of ships, the relevant costs need to be considered. In other words, these costs should be identified and quantified so then a decisionmaker would then be in a position to say how much funding should be set aside for this task.

Mr. JONES. Okay. Could you elaborate a little on the industry's recommendations on ways to improve the system of setting cargo rates for MSC cargo?

Mr. THURMAN. Certainly. We heard a number of suggestions; let me run through several of them. They start at about page 23 of the attachment to my statement.

Presently, the rate cycle for establishing shipping agreements is a six-month cycle. One of the suggestions that we heard from some representatives was that it would bring more stability to the entire system if that rate cycle were extended to one year.

MSC went to a six-month cycle, as I recall, back in the early 1970's, in response to industry concerns that conditions within the ocean transport sector changed rather quickly, and a six-month cycle would facilitate adopting to the changing market place. Therefore, the downside of extending it to one year would be to reduce the ability to adjust as quickly.

Currently, the shipping agreement that MSC uses is to award to the winning bidder up to 75 percent of the business that is carried on a particular cargo route.

We heard suggestions from some members of the industry that perhaps a better way to spread the work would be to reduce that percentage of award to 50 percent, and then the remaining 50 percent could be awarded to the other firms who were willing to come in on a "me too" basis and meet the bid of the successful offerer.

A concern on the part of MSC—and I think a legitimate concern, is that by reducing those percentages from 75 to 50 it would lower the incentive associated with the competitive process and the incentive to reduce the rate and assure that the Federal Government obtain the most reasonable rate possible under the circumstances.

Another suggestion we heard from a commercial carrier was that, rather than engage in a best and final offer process, which is part of the negotiation process and the award of shipping agreements, that it might be preferable to eliminate best and final offers on the grounds that quite often—at least in this particular company's view—original bids may be leaked to the competitors.

Other suggestions were that perhaps what we should do is go to a system similar to that of MAC—the Military Airlift Command. That command, in contracting for airlift services, goes through a process whereby the carriers identify the cost of their operations and MAC establishes a rate based on the addition of a profit to

those costs. That is not that dissimilar to a recommendation that was made by th· President's Commission on Merchant Marine and Defense which would move us toward a tariff-type system as opposed to a competitive bidding process.

MSC points out that there are some very fundamental differences between airlift and sealift in terms of the type and nature of cargo that is contracted for and the regularity of that contracting. So there are some issues associated with that approach which, in our view, would need to be fairly carefully explored if it is to be seriously considered.

I have probably given you too much; however, those were some of the key suggestions.

Mr. JONES. It has hit some very sensitive spots because there are things that could be linked with the contract and so on.

Mr. THURMAN. Yes, sir.

Mr. JONES. And percentage of distribution. That's very important to a lot of people.

Mr. Anderson?

Mr. ANDERSON. Mr. Thurman?

Mr. THURMAN. Yes, sir.

Mr. ANDERSON. The GAO study indicates that the major difference in cost between the MSC and the commercial firms result from crew costs in which the commercial firm is consistently higher. Could you please elaborate on why some of the commercial crew costs would be up to 60 percent higher than the MSC crew costs?

Mr. THURMAN. Yes, sir. Let me talk a little bit about that and point out, too, that we did not do an exhaustive study of the pay structure within the merchant marine, but I think I can hit the high spots for you.

In one of the cost comparisons which favored MSC, the overall commercial personnel cost was 15 percent higher than MSC's and was more than 60 percent higher in some positions. Also, contributing to MSC's lower crew costs was its use of lower rated crewmembers who were paid less than those offered by commercial firms.

Another key factor according to MSC, is that some union members in the merchant marine receive 30 days' leave for each 30 days at sea. I should point out that many firms have negotiated separate less-liberal agreements, depending on the circumstances of the assignment.

But, in contrast to that, Civil Service mariners working for MSC receive the same leave as any other Federal employee. In other words, 13 days for the first 3 years of service, and then up to 26 days after 15 years of service. That is a very key difference.

Mr. ANDERSON. That would make a 60-percent difference?

Mr. THURMAN. Well, there are other things that account for the difference. One of the things that I probably should point out and be clear about: the A–76 process is designed to identify lowest cost on either side irrespective of the inherent advantage or disadvantage that the commercial sector or the Government sector may have.

So, for example, in the commercial side one has to make a profit, assuming that you want to stay in business, pay your stockholders,

and so forth. There also is a fairly heavy insurance premium that commercial firms face in this arena.

But the big difference that we observed, Mr. Anderson, in the studies that we saw was in the crew costs, and that part accounts for a big piece of the difference.

If you look at the other benefits, in the commercial sector, it is fairly typical that pensions, life insurance, and other benefits are fully paid for by the employer. In the Federal sector, the costs of these benefits are shared between the Federal Government and the employee, so that, too, kicks into the equation.

Mr. ANDERSON. Thank you.

Mr. JONES. Mr. Sweeney?

Mr. SWEENEY. Thank you, Mr. Chairman.

Mr. Thurman, in comparing the commercial cost to Government cost in the merchant marine is there any way under the current system, in your view, that a private vessel operator can match the Government cost in crewing?

Mr. THURMAN. Mr. Sweeney, I think I would say from what we have seen to date it would be difficult. That was basically our observation after looking at the cost comparisons that have been conducted since 1982.

Mr. SWEENEY. I'd like to ask you a couple more questions.

Mr. THURMAN. Yes, sir.

Mr. SWEENEY. Do you think it is possible that we have overstated the purpose of the OMB Circular A-76? Overstated the intent which we base judgments on cost only?

As I understand the Circular, it wasn't just directed at cost alone.

Mr. THURMAN. To answer the first part, Mr. Sweeney, it seems to me that the issue we're addressing today goes exactly to that question on whether or not the Congress is satisfied with the outcome of considering just cost alone.

What the Circular attempts to do is to focus strictly on cost. In other words, it is a little different than the private/public shipyard competition, for example, where in that particular case the Congress acted to specifically exempt that process from OMB Circular A-76 in order to make adjustments and try to assure a level playing field.

Mr. SWEENEY. I understand that.

Mr. THURMAN. Yes, sir.

Mr. SWEENEY. But I spent three years in this Administration dealing with A-76——

Mr. THURMAN. Yes, it's a very——

Mr. SWEENEY [continuing]. Prior to coming here. And I know many people felt that the driving purpose behind the Circular was to get the private sector more involved—irrespective of cost in some cases—in procuring and producing Government services in many instances.

Mr. THURMAN. Right.

Mr. SWEENEY. So, do you think it is possible that we have just overstated and oversold the case as to how cost relates to A-76?

Mr. THURMAN. If you look at outcomes associated with A-76 throughout the Department of Defense, you will find, I believe that there is about a 50-percent split on the cost comparisons. In other

words, for all commercial activities that are studied for possible conversion from civil servant to contractor, about 50 percent are, in fact, converted.

I think on balance our work would tend to support A-76 as a good process. If nothing else, it causes the Government to take a look at how it carries out its work and whether or not it is doing it in the most efficient and most economical manner.

If I could step back and just talk about A-76 generally. The situation we observed in the maritime industry was a little bit different than what we normally see throughout government. Typically, what we get in GAO are concerns and complaints from the civil servants and their unions that they are unable to compete with the commercial side, and that seems to be a fairly prevailing pattern.

I think what we have seen in GAO as we've looked at A-76 over the years is that quite often what happens in the public sector is that the bureaucracy that is carrying out a particular function tends to get large.

People get promotions and in-grade pay increases and so forth which tend to drive up the labor costs. When a decision is made to compete a particular function, quite often what happens is that a commercial firm can come in and successfully assume that function because the wages and the size of the public sector workforce have increased over a period of time.

Generally, we see A-76 as a positive kind of process, and yet we have also seen individual cases where the scope of work that was outlined for both the public and the private sector to compete on was deficient, that maybe erroneous decisions were made as a result and so forth.

So A-76 is not without its problems, and certainly not without its emotion. But overall I think we see it as having a salutary effect on the Government.

Mr. SWEENEY. One last question. From your extensive review did you conclude that the MSC uses the A-76 process for all procurement action?

Mr. THURMAN. No. Let me give you some numbers. As of July 5, 1988, MSC had 130 ships in its fleet: 87 of those ships had commercial crews; 56 of the 87 were chartered from commercial firms and had civilian crews; and 31 were Government-owned ships with civilian crews.

The remaining 43 ships had Civil Service crews: 21 of those 43, at that particular date, were viewed by MSC as being exempt from the A-76 process because those ships operate in close support of combatant forces. But the remaining 22 have been either subjected to the A-76 process or are being considered for A-76 study.

In summary, Mr. Sweeney, there are about 21 of the 130 ships that are considered by MSC to be exempt from the A-76 process because of their mission.

Mr. SWEENEY. Thank you, Mr. Chairman.

Mr. JONES. Mr. Shumway?

Mr. SHUMWAY. Thank you, Mr. Chairman.

Mr. Thurman, every time we discuss this with you we always talk about the expense involved, and I notice you, likewise, make some reference there on the top of page four of your testimony. It says, "It appears that increasing the number of Government-owned

vessels operated by commercial firms would likely result in additional costs to the Government."

Mr. THURMAN. Yes, sir.

Mr. SHUMWAY. And you go on to say, "It is important that the additional costs be identified and disclosed rather than changing circulars"—that's the A-76 cost comparison process.

Has GAO done any actual cost estimates to support those points? Can you be more specific in that regard? We have to know the bottom line, and I guess maybe it's premature but have you looked at it?

Mr. THURMAN. Yes, sir. If you could turn to page four of the appendix, sir.

Mr. SHUMWAY. Is that appendix one or two?

Mr. THURMAN. Appendix one. I'm sorry.

Mr. SHUMWAY. That's all right.

Mr. THURMAN. At the top of the page are some of the numbers involved in the five cost comparisons that have been conducted since 1982. As you can see by glancing down those, with the exception of the second one, the cost associated with going to the commercial sector would have been substantially higher than keeping the ships in house.

Mr. SHUMWAY. So it would be the total of those two columns? Or the difference between the totals?

Mr. THURMAN. Each of those are individual A-76 studies. In other words, in the first one listed (the tanker study) the low commercial offer was $44.9 million, and the estimated cost for MSC to operate and maintain those ships was $28.5 million and so forth.

So they each have to stand pretty much on their own. But the results of these five studies were the basis for our conclusion that, if we directed more ships to commercial firms, there would be additional costs. In reaching that conclusion what we were really responding to was the suggestion on the part of some members of the maritime industry that perhaps in the interest of sustaining a viable merchant marine fleet the Navy should assign these ships that are available for A-76 comparison purposes to the commercial sector. The commercial sector alone would then compete for the operation and maintenance of these ships.

Our only point was that if we do that, based on what we have seen, it would increase the cost to the Government.

Mr. SHUMWAY. You didn't come up, then, with a bottom line figure as to the cost to carry out such a recommendation?

Mr. THURMAN. No, sir, I'm not sure I totally follow you. When you say "bottom line"——

Mr. SHUMWAY. What's going to be the cost that you refer to on the top of page four?

Mr. THURMAN. We did not come up with a bottom line.

What I think should be done and what we are suggesting is that—if the Congress decided it was in the national interest to enhance the health of the maritime industry—a very careful analysis of costs and benefits should be prepared for decisionmakers. But no, sir, we did not do that.

Mr. SHUMWAY. Thank you, Mr. Chairman.

Mr. JONES. Mr. Coble?

Mr. COBLE. No questions.

Mr. JONES. Thank you, Mr. Coble.

Mr. Thurman, thank you very much for your assistance and that of your colleagues this morning. You have been a very fine witness.

Mr. THURMAN. Thank you, sir. We stand ready to assist the Subcommittee in any way that we possible can.

Mr. JONES. I feel we need all the help we can get.

Mr. THURMAN. Thank you, sir.

Mr. JONES. Thank you.

Mr. JONES. Our next witness is Admiral Walter T. Piotti, Commander of the Military Sealift Command. Admiral, please come around. You are recognized, and you may proceed, sir.

STATEMENT OF VICE ADM. WALTER T. PIOTTI, JR., USN, COMMANDER, MILITARY SEALIFT COMMAND, DEPARTMENT OF THE NAVY, WASHINGTON, DC

Admiral PIOTTI. Thank you. Good morning, Mr. Chairman.

I have a prepared statement, and with your permission I would like it inserted in the record and at this time provide an oral summation.

Mr. JONES. All right. Your prepared statement will be inserted in the record.

Admiral PIOTTI. Mr. Chairman and Members of the Subcommittee, I am again pleased to appear before you and welcome this opportunity to discuss the procurement policies and practices of the Military Sealift Command, as well as our procedures implementing the national policy to achieve economy and enhance productivity promulgated by the Office of Management and Budget under circular A-76.

A detailed overview of the organization and missions of the Military Sealift Command is provided in my prepared statement; however, MSC's major function, and the one that is of primary interest to today's hearing, is that of ocean transportation or sealift.

MSC is assigned as the Department of Defense single manager operating agency for ocean transportation. As such, MSC is strongly dependent on a responsive, healthy, and efficient U.S. merchant marine.

Strategic sealift dictates a capability to deploy and sustain military forces whenever and wherever needed as rapidly and for as long as operational requirements dictate. Today, all DOD peacetime cargo requirements are being met through services procured commercially from the U.S. merchant marine; thus, the interests of the Navy and the U.S. merchant marine remain inextricably linked.

In the best of times, DOD is an important factor in the viability of the U.S. merchant marine; and, in its present depressed state, the U.S. maritime industry becomes more dependent on the Government for its economic survival.

The Department of Defense recognizes this interdependence, and over the last six years the U.S. Navy has spent $84 billion—or $12 billion a year—in the private sector in shipbuilding, modernization, repair, and maintenance programs.

Additionally, over this same period the Military Sealift Command has spent another $12 billion in the maritime industry for

services that include charter- and contract-operated ships, shipping agreement contracts for break bulk and container services, and for the procurement of sealift enhancement features and other equipment.

While these dollar figures are significant, cargo tonnage figures are also important in that they show the Department of Defense to be the most important single customer of the U.S.-flag merchant marine in their day-to-day operations.

In fiscal year 1987, MSC shipped more than nine million tons of dry cargo on privately-owned U.S.-flag commercial ships—ships either under charter to MSC or operating under MSC agreements or contracts. Further, DOD shipped another four million tons of household goods and personal property. This represents 20 percent of the total tonnage carried by U.S.-flag shipping.

For example, on the East Coast-to-Europe route, DOD cargo accounts for more than 50 percent of the U.S.-liner capacity.

MSC also exercises close oversight of the 1904 Cargo Preference Act, shipping more than 97 percent of its dry cargo and more than 92 percent of its petroleum products in U.S.-flag ships.

MSC is also required by the Armed Services Procurement Act, as amended by the Competition and Contracting Act, to obtain all goods and services through full and open competition.

A brief background of DOD's acquisition of ocean transportation services will assist in placing the issues before this Subcommittee in perspective.

Subsequent to the establishment of the Military Sealift Command—or the Military Sea Transportation Service in 1949—the name was subsequently changed to the Military Sealift Command in 1970—cargo was allocated among the carriers under a uniform cost basis rate structure.

Between 1963 and 1966, a sequence of events caused DOD to reform its system of procurement for ocean transportation services. These events included various comparative rate studies, the entry of a new lower-rate carrier in the North Atlantic, anti-competitive practices by established carriers on the North Atlantic, and a resulting Federal Maritime Commission investigation which ultimately found the rates and practices of carriers regarding DOD cargo to be unlawful.

Beginning with Fiscal Year 1967, DOD solicited competitive annual proposals from U.S. carriers which guaranteed a minimum amount of carriage on fixed trade routes and made awards on the basis of service, management expertise, offeror responsiveness, and cost. This current system fosters efficiency, quality of service, and economy within individual steamship lines now competing for DOD traffic on the basis of their individual asset availability, cost, and pursuant to their own in-house management decisions.

Each has definitive knowledge of the minimum amount of DOD cargo available during the period of the contract and are able to integrate their other operations accordingly.

The Commission on Merchant Marine and Defense recommended revision of the MSC liner procurement policy to a rate system based on established tariff rates. However, the representative of the majority of the U.S. liner operators, the president of the United Shipowners of America (U.S.A.), in testifying before the Commis-

sion in May of this year, stated that the current MSC procurement system is "An extremely complex issue, and quick answers may well cause more problems than already exist."

In further testimony before the Commission just last month, the United Shipowners president reaffirmed that position and recommended a thorough analysis be conducted on the tariff rate system and that, in the interim, U.S.A. preferred to continue with a "modified version of the existing bid system."

To better evaluate the Commission's recommendations, MSC tasked Harbridge House to conduct an independent analysis of the current system and to evaluate the possible impact of implementing the changes suggested by the Commission.

The Harbridge House report indicates that rates paid by DOD for liner services are consistent with the negotiated commercial rates paid by large shippers using the service contracts permitted by the 1984 Shipping Act.

The report added that the adoption of a tariff rate system would result in substantially higher costs. Harbridge House further concluded that some trade route tariffs appear to be little more than paper rates, with virtually all traffic moving under much lower priced service contracts.

The report added that the establishment of MSC rates based on filed tariffs as recommended by the Commission, would result in MSC paying higher rates than those paid by commercial shippers shipping lesser volumes.

Finally, the report concluded that an increase in U.S. liner revenues from the carriage of DOD cargo would not appear to increase the number of militarily-useful ships, as the types of ships DOD most needs in an emergency are the least efficient in commercial trade.

Some companies engaged in the carriage of DOD cargo have suggested that in order to bid certain restrictive criteria be applied. These recommendations appear to have a primary objective of limiting competition to existing companies rather than promoting free and open competition or improving efficiency, quality of service, or economy in the U.S. merchant marine.

It was for similar reasons that the Federal Maritime Commission found carrier methods unlawful during the 1960's. Further, such restrictions go well beyond the current requirements for Government guarantees under title XI of the 1936 Act.

The Competition and Contracting Act specifies two primary procedures to accomplish the full and open competition required by law. MSC uses the request for proposal or negotiation process.

Because of the complex nature of ocean transportation, this procurement method is most advantageous to the liner companies and most cost effective to the Government as it best assures DOD will receive the transportation services it needs at the lowest taxpayer cost and under terms most equitable to all carriers.

The request for proposal procedure guarantees all interested companies an equal opportunity to obtain MSC contracts.

As you are aware, commercial ocean rates fluctuate in relation to market forces including such independent factors as the relative strength of the dollar and its resulting impact on the level of ex-

ports, changes in tonnage capacity on particular routes, and the operating cost driven mainly by fuel and wages.

Accordingly, and in fairness to the carriers, in 1971, MSC shortened the effective period of rates from one year to six months. At the time, this change was received with strong industry support.

To illustrate how market forces affect shipping rates, I have provided in the statement for the record two charts showing the rate fluctuations resulting from these market forces on two major DOD shipping routes from 1979 to the present. These charts illustrate that DOD is affected by the same market forces as any other ocean shipper.

The combination of currency, exports, and operating cost fluctuation, together with competition, changes in capacity, and demand, in turn determine our rates, as well as those of all civilian shippers, for cargo on a particular route.

This is as it should be. Competitive procurement is a Government policy, and it forms a common basis for all Government purchases. It has brought significant savings to the taxpayers, sharpened the cost consciousness of contractors, and resulted in contractor investment in ways that have led to a strengthened industrial base and a stronger and more affordable national defense.

Turning to the matter of contracting for the efficient operation of Government-owned and bareboat-chartered ships, the Navy, in 1983, identified 30 ships then operated by MSC with Civil Service crews as having potential for commercial operation. Accordingly, MSC subsequently began a series of cost comparisons on those ships pursuant to OMB Circular A-76.

OMB Circular A-76 states that this form of competition should enhance quality, productivity, and economy. It further states that the policy of the Federal Government is to foster commercial activities, and the Government shall not start or carry on an activity to provide a commercial product or service that can be procured more economically from a commercial source.

To date, MSC has conducted A-76 studies on 27 ships, 12 of which have been subsequently turned over to commercial contract operation, while 12 remain as Civil Service-operated ships. Three other Government-owned ships were placed in the Ready Reserve Force (RRF) and replaced by commercial shipping employing private sector mariners.

These efforts have resulted in savings, plus avoidance of additional costs amounting to $115 million. The A-76 methodology in Government cost estimates has been thoroughly reviewed on each occasion by approval and oversight bodies. In each case, the MSC methodology has been accepted by all reviewing officials.

Mr. Chairman, the Department of the Navy fully supports the interest of the Congress in solving the problems of and revitalizing the U.S. merchant marine.

We have participated earnestly and significantly in many areas to help achieve this very necessary national goal and will continue to do so in the future. We will continue to work with the Congress and the maritime industry in whatever way we can to achieve the common goal we all seek—a U.S. maritime industry capable of meeting the Nation's economic as well as military needs.

In this regard, on 22 July the Department of Defense forwarded the Navy-originated National Sealift Policy to the National Security Council for approval and promulgation. This policy is a superb first step in refocusing responsibility for our national maritime welfare.

The Department of Defense feels strongly its obligation to help support the U.S. maritime industry while at once obtaining commercial transportation services that it requires at the most cost-effective rate. It believes just as strongly that its procurement of ocean transportation is consistent with that national procurement policy, as well as the national sealift policy and the national strategy, and that our methodology will continue to foster increasing stability, efficiency, and economy within the maritime industry.

Mr. Chairman, I thank you. I would now be glad to answer any questions you or other Members may have.

[The prepared statement of Admiral Piotti can be found at the end of the hearing.]

Mr. JONES. Thank you, Admiral.

Admiral, according to industry sources, since 1970, the number of major U.S.-flag liner companies operating five or more ships in the foreign trade has declined from 18 to only five companies. During this time, the total number of ships operated by these companies has declined from 434 in 1970 to 105 today.

Given the declining state of our merchant marine and the small number of U.S.-flag liner companies operating in the foreign trade, what suggestion do you have to address the industry's concern regarding the present cargo rate system being used by the MSC?

Admiral PIOTTI. Mr. Chairman, even though the number of liner companies has decreased, I think you will find that the tonnage carried by the remaining companies has increased significantly during the same period.

As regards the stable rate system, the largest shipper, the U.S. Government, would pay a rate that is more than that paid now under shipping agreements by commercial shippers.

To give you an example: The average commercial tariff rate on all of the major military trade routes today equates to about $85 a measurement ton across all commodities. The average commercial service contract rate on those same trade routes is about $45 per measurement ton. MSC, as the largest quantity shipper in the U.S., pays $42.50 on average. So our rates are very comparable to those that the liner companies have signed up to under their service contracts with commercial shippers. So, I do not think in any way that MSC rates are destructive.

Mr. JONES. All right, sir.

Are you aware—of course you are—that service contracts are frequently used as a rebating device to gain market share and may, indeed, provide prices which are not fully compensatory?

Admiral PIOTTI. I don't believe that to be so. They are compensatory to their actual costs. As we have discussed before in these hearings, the rate provided MSC for a lot of its cargo is fully compensatory to the carriers in accordance with the needs of their individual companies. By that I mean that in a time when there are more imports than exports there is a need to position containers overseas. The rates charged MSC in those instances fully cover the

cost for the handling of cargo, and they derive the added benefit of free placement of those boxes overseas for inbound cargo to the United States. Thus, the bid rates are in accordance with their own company needs.

Mr. JONES. All right, sir.

Admiral, Sea-Land has submitted a statement for the record here this morning, but I understand that you have reviewed it. Would you care to comment on their recommendations?

Admiral PIOTTI. I briefly reviewed it, and it is interesting to note that Sea-Land in its proposals—the six items or so that they would like to change—forgets its beginnings, which came about as a result of being allowed to bid for military cargo when they were an inexperienced operator, and now it appears that the recommendations that are contained therein are anti-competitive in nature. Additionally, we only have to look to the recent agreements with Nedloyd and TFL (Trans Freight Lines) to see the linkage between Sea-Land and foreign carriers—which they speak out against.

I haven't had a chance to take a look at it in depth, but I think we have to go back to what F.D.R. said when he established the ODS and CDS subsidies. He said, "We must learn to call a subsidy a subsidy and to not be misled by trying to place costs where they don't appropriately belong."

[EDITOR'S NOTE.—See MSC letter, dated 30 September 1988, at end of hearing.]

Mr. JONES. All right. Thank you, Admiral.

Mr. Anderson, do you have any questions?

Mr. ANDERSON. Admiral, the study by the GAO indicates that the Ready Reserve Force ships have been used increasingly for extended activation; however, you do not foresee the need for extended activations in the future. Why do you not foresee extended activations in the future?

Admiral PIOTTI. One of the things we look at is the overall cost of all exercises. We do that in conjunction with the JCS exercise budget for their sponsored exercises, which include sealift and airlift, the cost of moving things, people, and the like. Of course they want to keep those at a minimum.

When we activate an RRF ship, the breakout charge alone is a half a million dollars. So, if we use that ship one time, we pay that half a million dollars. If we then subsequently return that ship to the RRF and break it out a month later it is another half a million dollars. To avoid that repetitive cost in the past, we have kept these ships broken out when they met the exercise requirements and thus didn't pay that repetitive half-million dollar cost.

For the future because of other fiscal realities the number of exercises, as well as the duration of those exercises has decreased. There will be some exercises, such as the two major exercises which MSC participates in— REFORGER, which is coming up this month and for which we have already started the loading of equipment to take to Europe, and TEAM SPIRIT in the Far East where we will operate the ships for extended periods because the exercise runs longer than 120 days. So, those are the only exercises which I foresee in the future where we will have RRF ships activated for a period greater than 120 days.

These ships pick up their loads—whether it be in Beaumont, Texas, or other places in the continental United States—and drop it off in Antwerp, and then they will be layberthed until the retrograde cargo is ready to come back.

Mr. ANDERSON. Did you anticipate the need for extended activation prior to the GAO study?

Admiral PIOTTI. The extended activations which are referred to in the GAO report came about long before the GAO report. Most of them occurred about a year or a year and a half ago.

We don't anticipate and never in the past did we anticipate any extended activations beyond those 120 days except in the exercises which I have mentioned, and with the possibility of one other, and that is BRIGHT STAR on the African Littoral.

Mr. ANDERSON. So it wasn't a GAO study then that brought about the result of not having a need for extended activation?

Admiral PIOTTI. No. The GAO just pointed out that we have reduced the number of extended activations, but they took place long before GAO studied this particular issue.

Mr. ANDERSON. Thank you.

Mr. JONES. Mr. Sweeney?

Mr. SWEENEY. Good morning, Admiral. As one who serves on the Armed Services Committee as well, let me say that I think we have the finest United States Naval Force in the world. I only wish I could feel as confident about our merchant marine operation and our Military Sealift Command, which brings me to my question.

You no doubt are familiar with the policies that other countries have adopted with the intention of preserving or strengthening or expanding their own military sealift capabilities. How would you compare this Country's policies to those of other nations?

Admiral PIOTTI. Other countries have established protectionist measures that work against our merchant marine. And the Maritime Administrator and Congress, in the Trade Bill and other trade initiatives, have tried to address those.

These protectionist measures include such things as the subsidy of shipyards, direct subsidy of their merchant marine, low-cost/no-cost loans for shipbuilders, for operating companies, and other protectionist measures which include no United States or foreign infrastructure for the inland movement of cargo, the off-loading of cargo, etc.

We have tried to tear down these barriers to level the playing field for the U.S. merchant marine. However, there are those that would advocate erecting similar barriers and increase subsidies to the United States' merchant marine industry.

I think we have to determine what our economic and military needs are and to then determine what it is going to take to satisfy those requirements in terms of a merchant marine, and then, up front—and in one place so it is readily recognizable—determine what subsidies, if any, are needed.

Mr. SWEENEY. And you feel that our sealift capability today is adequate for defense purposes?

Admiral PIOTTI. No, it is not. As I have stated before this Committee on several occasions, we have about a half-million deadweight ton shortfall in dry cargo, 35 handysize tankers, and a

shortfall of personnel ranging from 6,000 to 8,000 just to meet our military needs.

Mr. SWEENEY. And does not the GAO study then present some rather disturbing conclusions for you?

Admiral PIOTTI. As was said by the Chairman, and as said by Mr. Thurman, my responsibility is under the Procurement Contracting Act. This does present a problem if when I go out under contract our policy does, in fact, cause a decline. I don't think it does, because as I have stated here before, the shipping agreements and MSC contract prices are about equal.

But if it does, and a shortfall—a continuing shortfall—results, then that places an added burden on the Government for what doesn't exist in the commercial fleet for use by the military in a national emergency, then it has to exist within the Government fleet; i.e., the RRF.

It makes infinitely more sense to me to have a healthy, viable merchant marine that we can draw on in peacetime and wartime rather than have this large parking lot of ships which are tied up only for emergency.

Mr. SWEENEY. I have one last question. You are familiar with the reference made earlier to appendix one, page four. I think there were five categories—tanker, oceanographic, hospital, cable, and range instrumentation. Only in one category was the commercial offer lower than the MSC cost. Now, why only in that one category would that hold true, and yet not in the other four categories? In your view of the other ship types, would the MSC cost be so much lower?

Admiral PIOTTI. If I can take a few minutes. There are several reasons for that.

In that particular instance, the crew size difference was significant—that proposed by the low commercial offeror was 447 for the crewing of those 12 ships.

Mr. SWEENEY. Compared to 524. Yes.

Admiral PIOTTI. That's total crewmembers. He proposed 447, and the Government proposed 524. So his crew costs were much lower than the Government's, and that constitutes the majority of the cost difference. In the other cases, of course, there were things which work against any commercial offeror. First, he must beat the Government's bid by ten percent. The Government does not make a profit, so that is not added in. Injuries to Civil Service employees are covered by the Federal Employees Compensation Act system; a contractor has to buy P&I insurance. A contractor also has to pay for the cost of money; the Government doesn't.

So, there are these and other certain advantages which accrue to the Government.

Mr. SWEENEY. But in this one case there is a significant difference between the commercial offer and the Sealift Command cost. I'm just wondering how that could be duplicated in the other ship types—for tankers, for hospitals, for cable, for either conversion or actual building of many of these other ship types. Just lowering the crew cost? That would be your answer? If it can be done in one case, I'm just asking why it is not possible to achieve——

Admiral PIOTTI. Well, had we used crew sizes similar to those used by the contractor—in all probability the Government would

have won that competition also. We basically put too many people back on those ships.

Mr. SWEENEY. Thank you, Mr. Chairman.

Mr. JONES. Admiral, thank you very much for your appearance here this morning and your continuing interest in the merchant marine's well being. Thank you.

Admiral PIOTTI. Thank you.

Mr. JONES. Our next witness is Mr. Phil Grill, Vice President of Government Relations at Matson Navigation Company, Incorporated.

Phil, the Chair is happy to recognize you.

STATEMENT OF PHILIP M. GRILL, VICE PRESIDENT, GOVERNMENT RELATIONS, MATSON NAVIGATION CO., INC.

Mr. GRILL. Good morning, Mr. Chairman. Thank you.

Mr. Chairman, I very much appreciate the opportunity to appear before you this morning and would like to summarize my written statement which has been submitted for the record.

Mr. JONES. Your prepared statement will be inserted in the record.

Mr. GRILL. The purpose of my statement is to ensure that the Subcommittee is aware of a system of Military Sealift Command transportation procurement in the Pacific Coast/Hawaii trade that permits a constructive working relationship to exist between MSC and the Jones Act carriers, and which ensures that both MSC and the carriers are treated equitably. ,

In the domestic/Hawaii trade, Matson files a significant majority of our rates at the Federal Maritime Commission. There they are subject to rate of return regulation. This means that the FMC limits our freight rates so that Matson revenues will not exceed a level that will return our cost, plus a reasonable profit. Essentially, it is these FMC-regulated rates that the MSC uses.

It is interesting that prior to 1974, Section 6 of the Intercoastal Shipping Act explicitly permitted the carriage of Government and charitable cargoes in the domestic offshore trades for free or at reduced rates relative to the corresponding commercial rate.

The effect of Section 6 was that substantial amounts of military cargo were carried at rates that were significantly lower than the corresponding commercial rate so that, in effect, the higher-rated commercial cargo was subsidizing the military cargo.

Recognizing this problem, in 1974 this Committee, together with the Senate Commerce Committee, recommended legislation that repealed Section 6 and made it clear that the rates charged for the carriage of Government cargo in the domestic offshore trades would be subject to the same type of economic regulation by the Federal Maritime Commission as the Commission exercised over commercial rates. This has been the case since 1974.

In the Hawaii trade, the FMC regulates the reasonableness of Matson's rate of return on rate base, and they have been very active in using this statutory authority that they have.

Most recently, the FMC suspended, investigated, and disallowed a two-and-a-half percent rate increase that Matson proposed to become effective in January of 1986. As part of that same action,

they further rolled existing rates back by one-and-a-half percent. As a result, for the five-and-a-half years since January, 1983, Matson's rates have increased by only one percent.

Since the Military Sealift Command essentially uses these same FMC tariff rates, we feel that it is certainly a fair statement to say that the FMC regulation ensures that MSC freight rates are not excessive and will only yield the carrier a fair rate of return on its investment.

The MSC, as I understand it, is contemplating plans to move ahead with a competitive procurement system in the Pacific Coast/Hawaii trade. If they do that, clearly, there will be a significant reduction in military freight rates in that trade.

The MSC is much larger than any other single commercial customer, obviously because they are a part of the taxpayer-supported Federal Government. They can use this extraordinary economic bargaining power to introduce a competitive bidding system that will award large blocks of military cargo to the lowest bidder.

In this highly fixed-cost maritime business, if the carriers are faced with the prospect of losing significant volumes of military cargo, clearly, these rates are going to come down. But if that happens we will be back to where we were prior to 1974 when the commercial shippers were subsidizing the military rates.

The December, 1987, report of the Commission on Merchant Marine and Defense recognized these problems in MSC's current procurement policy, and recommended that MSC adopt a system that would provide rate stability and reasonable rates of return on investment.

Matson feels that this is the type of system that is currently in use in the U.S. Pacific Coast/Hawaii trade. We feel it is equitable to everyone and should be continued.

I thank you, Mr. Chairman. That concludes my statement.

[The prepared statement of Mr. Grill can be found at end of hearing.]

Mr. JONES. Thank you, Mr. Grill. I have two or three questions.

Do you oppose the MSC's plan to go to a bid system?

Mr. GRILL. Mr. Chairman, as I have stated, we feel that the current system of Federal Maritime Commission rate of return regulation limits Matson's freight rates in an overall sense to a level that caps our rate of return to a reasonable level. This is a very extensive process where our financial data is subject to very detailed scrutiny at the Federal Maritime Commission.

So, to the extent that we are going to see a system that would distribute large blocks of cargo depending upon who submits the lowest bid, yes, Matson would oppose a system like that.

Normally, if another carrier who is a competitor of ours would beat a Matson rate, or vice versa, the other carrier makes an adjustment. That's a continuing process. But under a competitive bidding system—and I understand MSC is talking about a one-year cycle in this domestic trade—if your bid is $1 higher than the other competitor, then the low bidder would get all of that particular category of cargo for the entire one-year cycle.

Mr. JONES. If the MSC were to go to a bid system, in your opinion would rates be stable and would operators earn a reasonable rate of return? Can you answer that?

Mr. GRILL. I think that history provides an answer to that question. Prior to 1974, we had a situation where that type of system was in place in the domestic trades. It was really the shippers who initiated the legislative action and legislative remedy that this Committee approved in 1974, which was to subject military rates to the same kind of economic regulation at the Federal Maritime Commission that the commercial rates were subject to.

So, I would have to say no; I don't think this new system would promote rate stability.

Mr. JONES. Finally, do you think the way the FMC determines fair rates of return needs to be changed?

Mr. GRILL. Mr. Chairman, there are improvements that can be made in that system, and we have looked at legislation that would reform the rate of return regulation that the FMC currently exercises. But, essentially, it has worked reasonably well.

Mr. JONES. Mr. Anderson?

Mr. ANDERSON. Mr. Grill, the GAO study indicates that since 1970 the number of major United States-flag liner companies operating in foreign trade has declined from 18 to only 5 companies. Furthermore, the total number of ships operated by these companies has declined from 475 in 1970 to only 105 today. Does this indicate that ships are carrying less cargo or using larger, more efficient ships to carry more cargo, as reported by the MSC?

Mr. GRILL. Mr. Anderson, I really don't have the expertise to answer that question. Matson operates strictly between the West Coast and Hawaii in the domestic trades, and you are asking me a question about the foreign trades. I just don't feel qualified to respond to that question.

Mr. ANDERSON. Well, you might do it for the record.

Mr. GRILL. Yes, sir. I would be happy to do that.

[The material to be supplied follows:]

UNITED STATES/FOREIGN TRADE CARGO

According to the 1987 Maritime Administration Annual Report, in 1986, U.S.-flag liner vessels operating in the U.S./foreign trades carried 14.3 million tons, or 19.9 percent of the total 71.8 million tons of liner cargo. In 1977, U.S.-flag liner vessels carried 14.4 million tons, or 30.2 percent of the total 47.8 million tons of liner cargo moving in the U.S./foreign trades. The Maritime Administration's 1988 publication, "Merchant Fleets of the World" reports that for 1976 and 1986 the average U.S.-flag freighter was 16,400 deadweight tons and 23,300 deadweight tons, respectively.

Since the tons of U.S./foreign trade liner cargo carried by U.S.-flag ships has essentially remained constant over the last 10 years while the size of the average U.S.-flag liner vessel has increased by over 40 percent, these facts demonstrate that fewer U.S.-flag liner vessels are carrying more cargo today than they were 10 years ago.

Mr. ANDERSON. Kind of to follow up, does the existence of only five companies as opposed to 18 increase or decrease the nature of competitiveness for MSC contracts?

Mr. GRILL. Well, the MSC competitive procurement system in the foreign trades is different from what they are contemplating for the domestic trade.

As I understand it, MSC is contemplating a system for Hawaii that is similar to what they now have in Puerto Rico. Your hearing this morning focused strictly on the foreign trade procurement

system, and I'm just not familiar enough with that to respond to you. Again, I'd be happy to supply an answer for the record.

Mr. ANDERSON. Why don't you answer both of the questions for the record?

Mr. GRILL. I'll be happy to do that.

[The material to be supplied follows:]

COMPETITIVE BIDDING FOR MSC CARGO

I do not believe that the number of liner companies bidding for MSC cargo will, in itself, significantly impact the level of competitiveness for that MSC cargo. The level of competition for MSC cargo will be more heavily impacted by factors such as the amount of overcapacity in the particular trade route in which the MSC cargo is moving. Further, the high degree of fixed costs associated with vessel operations has always pushed ocean freight rates in the direction of incremental pricing since, whether a vessel sails full or three-quarters empty, it costs about the same to make the schedule voyage. Yet, if all ocean freight rates were set on an incremental basis, the incoming revenue, clearly, would be insufficient to support a maritime company's full operating costs. Finally, the structure of the Military Sealift Command's bidding system which awards large blocks of cargo to the lowerst bidder is the real key to the level of competition. This system has created a degree of competition in this highly fixed-cost maritime business that is so destructive that it has resulted in some bids being submitted so low that they may have actually contributed to the financial failures of some U.S.-flag companies, according to the December 1987 report of the President's Commission on Merchant Marine and Defense.

Mr. ANDERSON. Thank you, Mr. Chairman.

Mr. JONES. Mr. Bateman, we'd welcome a word from you.

Mr. BATEMAN. Thank you, Mr. Chairman.

Let me do a little reading, and maybe I'll have some questions; but, unfortunately, I didn't hear the witness.

Mr. JONES. Well, we'll recess for a minute.

Mr. BATEMAN. Mr. Chairman, I don't think that will be necessary. I sure don't want to delay you or the rest of the Committee or the witnesses. If I have any questions I will submit them for the record.

Mr. JONES. All right, sir.

Without objection Mr. Bateman may submit questions.

Mr. Grill, thank you very much for your appearance here this morning. That concludes our hearing.

Mr. GRILL. Thank you once again, Mr. Chairman.

Mr. JONES. The Committee stands adjourned.

[Whereupon, at 11:30 a.m., the Subcommittee was adjourned, to reconvene at the call of the Chair.]

[The following was submitted for the record:]

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U.S. House of Representatives
Committee on
Merchant Marine and Fisheries
Room 1334, Longworth House Office Building
Washington, DC 20515-6230

August 8, 1988

TO: MEMBERS, SUBCOMMITTEE ON MERCHANT MARINE

FROM: Majority and Minority Staff

SUBJECT: Oversight Hearing on How Military Sealift Command (MSC) Policies and Procedures Affect the Development and Maintenance of the American Merchant Marine (Tuesday, August 9, 1988)

INTRODUCTION

At 10:00 a.m. on Tuesday, August 9, 1988, the Subcommittee on Merchant Marine will hold an oversight hearing on how Military Sealift Command policies and procedures affect the development and maintenance of the American merchant marine.

BACKGROUND

The Honorable Mario Biaggi on January 21, 1988 asked the General Accounting Office (GAO) to investigate the policies and procedures of the Military Sealift Command, which many in the maritime industry said were unfair, unreasonable, and hastening the destruction of the American merchant marine. The MSC is the command within the Navy responsible for transporting all Department of Defense seaborne cargo. Civilian-manned ships that the MSC controls carry out its primary responsibilities of Strategic Sealift, Naval Fleet Auxiliary Operations, and Special Mission Support. In carrying out these responsibilities, the MSC uses Government-owned ships, scheduled commercial liners, and chartered commercial vessels. The ability to successfully deploy and sustain military combat power depends on transportation -- primarily sealift.

Our country needs adequate sealift capacity because there is no time to build the ships needed in the event of a war or national emergency. Ships carry more than 95 percent of the equipment and supplies needed to sustain a war effort. World history is replete with missions evidencing the importance of

sealift. Two examples are the American convoy-and-supply operations essential to Allied victory in World War II and the 8,000-mile sealift that ensured British success in the 1982 Falklands campaign. Without the strategic resource of sufficient military sealift, U.S. military missions are fatally flawed. The MSC's primary mission is providing sealift for strategic mobility in support of national security objectives. Inherent to this mission, which is called Strategic Sealift, is the capacity to deploy and sustain military forces whenever and wherever needed, as quickly and for as long as operational requirements dictate.

In peacetime, the MSC fulfills the mission by employing U.S. Government-owned ships and chartering ships from the American merchant marine. The vast majority of additional shipping required in the event of a war or national emergency must be chartered or requisitioned from the American commercial fleet.

The Maritime Administration (MARAD) reports that, since 1970, the number of major U.S.-flag liners operating in foreign trade has declined from 18 to only five companies. During this time, the total number of ships these companies operate dropped from 475 in 1970 to 105 today. Moreover, the total dry cargo deadweight tonnage these ships can carry has declined from 6,112,000 to 2,843,000 tons.

In its recently completed report, GAO identified three main areas of concern: (1) the use of cost comparisons in determining who operates and maintains MSC ships, (2) the current system of setting cargo rates for MSC cargo, and (3) the use of Ready Reserve Force (RRF) ships.

Use of A-76 Cost Comparisons in Determining Who Operates and Maintains MSC Ships

Private companies operate two-thirds or 87 of the 130 vessels connected to the MSC. Fifty-six of the 87 vessels are chartered from private companies, while commercial firms operate the remaining 31 Government-owned vessels. Civil servants man the remaining one-third or 43 vessels. Twenty-two of the 43 vessels Civil servants currently man could be operated commercially. Navy crews must operate the other 21 ships. These manning statistics are important because they reflect the overwhelming commercial operation. Further, the striking difference in the rates commercial companies and the Government pay merchant seamen often determines whether the function is contracted out.

The U.S. merchant marine is in a state of decline and relies on the MSC for a significant portion of its business. The single manager operating agency for sealift services within the Department of Defense, the MSC employs a workforce of nearly 4,000 Civil Service mariners to operate and maintain certain Government-owned vessels. These ships include tankers and cargo vessels as well as special project ships such as oceanographic research, hospital, cable laying and repair, and range instrumentation ships.

In 1981, the Office of Management and Budget formulated the OMB Circular A-76 Program, which directed Federal agencies to determine whether private companies could take over functions the Government was performing at a lower cost. The A-76 program is intended to provide the Government with commercial-type services at the lowest cost. The comparison consists of the lowest contractor's offer being compared to the estimated cost of the Government performing the service. Since 1982, the MSC has completed five cost comparisons under OMB Circular A-76 provisions to determine whether commercial firms or its own Civil Service mariners would operate and maintain these vessels more economically. A-76 requires that the commercial bid must be 10 percent lower than the Government's cost proposal to win a contract for an activity the Government had been performing in-house. If the MSC submits the lowest bid, the MSC continues to do the work in-house.

In evaluating the MSC's use of A-76, it may be helpful to review the contracts awarded during the last six years. Until 1982, the MSC operated its own ships. 1982 marked the first year that the MSC used the OMB Circular A-76 procedure to compare Government and commercial operator costs. In 1982, a contract to operate three tankers was kept in-house when the MSC submitted the lowest bid. Two years later, a commercial operator submitted a lower bid than the MSC and won a contract to operate 12 oceanographic ships. In 1987 and 1988, the MSC's costs were deemed lower for operating two hospital ships, five cable ships, and five range instrumentation ships. Industry representatives protested the awards for the hospital, cable, and range instrumentation ships. The Government won the competition to operate one of the hospital ships by initially setting manning requirements so low that no captain or other officer would be on a 1,000-bed vessel. When GAO investigated the hospital case in response to a bid protest, it concluded that MSC procedures were followed. GAO also denied the industry's bid protests concerning the cable ships. Seasoned maritime observers concluded that the manner in which the cable ship contract was handled calls the integrity of the contracting process into question. GAO has not yet ruled on the bid protest for the range ships submitted in March 1988. Because the MSC uses the A-76 program to procure ocean transportation at the least cost to the Government, operators seldom win bid protests.

The Government enjoys inherent advantages under the A-76 program. In the cost comparisons favoring the MSC, the largest differences were in crew costs. While the pool from which the seamen are drawn is the same, the crews manning MSC vessels earn lower wages than do the merchant seamen working for commercial operators. For example, unlike the merchant mariners the operators employ, MSC crews are not paid overtime and do not earn a

month of vacation for each month they sail. The MSC does not have to include general and administrative costs in its cost proposal unless a position would be eliminated if the function were contracted out. Industry has to include a full proportionate share of overhead in its cost proposals in order to recover its costs.

Another difference is that the Federal Employees' Compensation Act limits the Government's liability for workers' injuries while commercial operators are not only liable for medical injuries but also can be sued for mental duress, suffering, etc., which may result in large judgments. As a result, the MSC computes its insurance costs at .0007 times personnel costs, while commercial operators must allow for substantial insurance premiums and deductibles.

Another inherent disadvantage to commercial operators is the A-76 requirement that a commercial operator's bid must be 10 percent lower than the Government's for an activity the Government had been performing in-house. Finally, operators allege that the MSC requires that commercial operators maintain and repair their vessels to meet higher standards than those imposed on Government vessels.

Industry representatives are concerned with the way MSC participates in the OMB Circular A-76 process as well as with the way MSC administered a contract awarded to a private company to operate an oceanographic vessel. Operators believe the MSC's success in winning four of five A-76 cost comparisons is hastening the decline of the civilian merchant mariner workforce. Some believe they cannot win competitions under these procedures and plan not to make offers on further solicitations. The MSC argues that, since the Government and not commercial firms operated the ships before, the cost comparisons actually offer the civilian merchant marine opportunities for expansion. Further, the MSC asserts that the size of the merchant mariner workforce is not necessarily affected since both the MSC and private companies draw from the same finite pool of mariners.

Current System of Setting Cargo Rates for MSC Cargo

The MSC is responsible for the ocean transportation of Department of Defense (DOD)-sponsored cargo. To move this cargo, it uses chartered ships and contracts for space on commercial ships U.S.-flag carriers own and operate. Contracting for ocean transportation services is done primarily through shipping agreements for containerized and breakbulk cargo. Every six months, carriers submit bids offering a fixed price per ton of military cargo for each of the major shipping routes. Cargo rates, terms, and conditions are determined in accordance with the Armed Services Procurement Act, the Competition in Contracting Act, and the Federal Acquisition Regulation (FAR). If an operator submits the lowest bid, the MSC awards up to 75 percent of the cargo carried on the designated route to the lowest bidder. The next lowest bidder(s) carries the remainder of the

cargo. The percentage of cargo awarded to a particular bidder depends upon the trade route and the number of bidders. The MSC also uses tariffs in trade routes which are not covered by shipping agreements. The MSC and commercial carriers use the tariffs the ocean carriers file with the Federal Maritime Commission.

It is important to bear in mind that the MSC does not consider itself a promotional agency. If the MSC's objective is to carry Government freight at the lowest cost, it is doing an outstanding job. The problem for both the Government and the merchant marine is that, if the merchant marine continues to deteriorate, the Government will have to bear the considerable expense of building and maintaining vessels to replace the merchant vessels that used to carry military cargo.

The trade imbalance, worldwide overcapacity, and lower operating costs for foreign operators have resulted in a shortage of commercial cargo for U.S.-flag operators. Commercial operators report that the shortage of commercial cargo has forced them to submit noncompensatory bids to MSC and operate at a loss. In some cases, commercial operators assert that they have had to pay the Government for the privilege of carrying Government cargo. As a result, a number of operators no longer compete for MSC contracts. The MSC's ability to charter vessels to compete with commercial vessels is virtually unlimited. Companies will carry Government cargo at noncompensatory rates in hopes of carrying commercial cargo on the return voyage. Low rates are driving companies out of business and forcing the Government to buy more RRF vessels.

Operators criticize MSC procedures and policies. They say that Request for Proposals (RFP's) are so long and complicated that many struggling operators cannot spend the time and money to submit bids. Operators allege that MSC workers have expected them to meet criteria not in the RFP. Bidders say it does not make good business sense to tie up capital while the bid process drags on or bids go to unqualified entrants to the trade. While operators remain in limbo, the MSC routinely gets its deadlines extended. Seasoned operators want eligibility standards guaranteeing that only experienced companies owning ships and meeting Navy standards be allowed to bid.

MSC and the Ready Reserve Force

In times of national emergency, merchant ships augment the Ready Reserve Force. The RRF is a program funded and managed through MARAD to maintain inactive merchant ships in a state of readiness that would permit their reactivation within five, ten, or twenty days of notification. The sources of RRF vessels are: commercial ships bought through competitive procedures, ships from the National Defense Reserve Fleet (NDRF) upgraded to meet RRF standards, and ships removed from active MSC service. RRF ships are used in periodic military exercises to carry containerized, roll-on/roll-off (RO-RO), or breakbulk cargo.

Some ocean carriers believe that RRF ships have been used in multiple military exercises for extended periods of time. The carriers define extended periods as over 60 days. The operators assert that these long exercises take opportunities to carry cargo away from commercial operators. The carriers also argue that RRF ships have been placed in a reduced operating status in which they were idle for long periods of time awaiting Government retrograde cargo or cargo for the next exercise. The MSC asserts that carrying military cargo on RRF ships during military exercises is a valid use of RRF ships. However, the MSC acknowledges that RRF ships have been used of increasingly longer periods than in the past and have participated in sequential exercises in an effort to realize savings in activation costs. Beginning in the Fall of 1987, the MSC began concerted efforts to carry exercise cargo in commercial ships whenever possible.

The Bennett Commission on DOD Procurement

In a report released on December 30, 1987, the Commission on Merchant Marine and Defense (Bennett Commission) found that some Department of Defense and Department of Navy regulations, policies, and procedures hurt the American maritime industry. The Bennett Commission emphasized that voluminous, often complex RFP's require operators to spend a lot of money and time preparing bids. Moreover, MSC tanker scheduling policies result in a number of spot charters being given to foreign-flag tankers. In the desperate attempt to get military cargo, some operators have submitted noncompensatory bids. The practice of submitting bids so low as to be destructive has contributed to some operators' financial failures.

The Bennett Commission proposed policies and procedures to reverse this serious problem. Immediate changes were recommended to improve the merchant marine industry's stability; enhance our sealift capability; give commercial operators rates that more accurately reflect fully distributed costs and ensure reasonable rates of return on investment; furnish the Department of Defense comparable, fair shipping rates available from more than one carrier on the same route; stabilize shipping rates for a longer time period; encourage U.S.-flag carriers to upgrade new ships and equipment that increase productivity and meet military as well as commercial requirements; and prevent inexperienced, insufficiently capitalized carriers from furnishing unsatisfactory service. The Bennett Commission recommended that the Defense Department work with the Federal Maritime Commission and the Maritime Administration to change the method for soliciting ocean transportation services to a stable rate system based on the established tariff rates used for commercial shippers.

ISSUES

(1) Should the method of contracting for the ocean transportation of cargo further the goal of the least short-term cost to the Government or of fostering the American merchant marine? Which goal does current MSC contracting procedures further?

(2) What are the long-term costs to the Federal Government and to our sealift capacity of continuing to employ A-76? Should the A-76 procedure be deemed inapplicable due to national security considerations? Specifically, should the MSC limit competition to commercial operators and award the contracts to private companies to foster the American merchant marine?

(3) Are commercial operators submitting compensatory bids? If not, what impact does submitting low bids have on commercial operators and our military preparedness? Can any parallels be drawn between low balling in Navy shipbuilding and repair contracts and MSC contracts?

(4) Do the inherent savings to the Government prevent an accurate comparison of Government and commercial operator costs? If costs were computed using the same factors for Government and commercial operators, would any work have gone to a commercial operator rather than the MSC?

(5) What effect would replacing A-76 procedures with a program similar to the one the Military Airlift Command (MAC) uses -- or with a tariff system -- have on the American merchant marine?

(6) Should companies be paid to meet mobilization requirements and receive percentages of cargo based on their contributions to mobilization?

(7) Can the existing MSC contracting procedures be modified without continued harm to commercial operators?

(a) If the Government wins an A-76 competition, should commercial operators be allowed to get the contract by agreeing to operate MSC ships at the Government's bid price plus appropriate cost adjustments?

(b) Should the length of contracts be extended from six months to one year?

(c) Should the percentage of cargo given to the winner be lowered to give more operators part of the cargo?

(d) Does the MSC change the rules governing contracting in the middle of a bidding period?

(e) Do A-76 procedures give commercial operators a fair chance at the business for which they are competing with the MSC?

(f) Should MSC contracting workers be replaced with field officers that would follow commercial practices?

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(8) Should the MSC be limited to running vessels that are intimately involved in national security -- such as ships used to transport nuclear materials, destroy submarines, and conduct other missions requiring military discipline?

(9) Should operators be asked to establish the ability to perform the work before competing for MSC cargo?

STAFF CONTACTS:
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Minority: Kip Robinson/Rusty Johnston, x63492

cc: Members, Committee on Merchant Marine and Fisheries

PREPARED STATEMENT OF BILL W. THURMAN, DEPUTY DIRECTOR FOR PLANNING AND REPORTING, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE ON AUGUST 9, 1988

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our review of certain policies and procedures of the Military Sealift Command (MSC) and the concerns voiced by members of the U.S. Merchant Marine regarding their impact on the industry. Their concerns are in the areas of (1) the use of cost comparisons in determining who operates and maintains MSC ships, (2) the current system of setting cargo rates for MSC cargo, and (3) the use of Ready Reserve Force (RRF) ships. My statement summarizes our findings on these three areas. More details are provided in the appendixes.

Use of Cost Comparisons in Determining Who Operates and Maintains MSC Ships

In an attempt to operate its ships at the least cost to the government, MSC, since 1982, has completed five cost comparisons under the provisions of OMB Circular A-76 to determine if commercial firms or its own civil service mariners would provide the most economical operation and maintenance for a total of 27 MSC ships. Four of these comparisons favored MSC's operation of the ships and one favored the commercial firm.

The decision favoring the commercial firm showed a difference of about $24.8 million between the low commercial offer and MSC's cost for the operation and maintenance of 12 oceanographic ships. On the other hand, the four decisions favoring MSC showed, in total, a difference of about $65.2 million between MSC costs and the low commercial offerors' costs for operating and maintaining tankers, hospital, cable, and range instrumentation ships -- a total of 15 ships.

The intent of OMB Circular A-76 is to provide the government with commercial-type services at the lowest cost. The provisions of this circular require that a cost comparison be made between the lowest contractor's offer and the estimated cost if the government performed the service.

Some of the commercial firms believe that all the operation and maintenance of MSC ships should be performed by the commercial sector. Also, some commercial representatives believe that certain provisions of the circular favor the government in its cost estimating procedures. For instance, in determining its overhead costs, the government need only include the cost associated with direct supervisory positions one level higher than the activity under review, and administrative support positions that would be completely eliminated if the function were contracted out.

MSC believes that, since most of the ships in question have previously been operated by MSC, OMB Circular A-76 comparisons actually offer commercial firms and non-government mariners opportunities that did not formerly exist. Additionally, MSC believes the size of the merchant mariner work force is not necessarily affected by the outcome of the A-76 comparisons since MSC and commercial firms both draw mariners from the same finite pool.

Our examination of the cost comparison favoring the commercial firm showed that the biggest single difference was the size of the crew. The commercial offeror proposed to operate each ship with a smaller crew than MSC. Although MSC's civil service wage rates were lower, they were not low enough to offset the difference in manning. MSC officials told us that in preparing this proposal they misestimated the crew size.

In the cost comparisons which favored MSC, we found that the largest differences were in crew costs, resulting primarily from higher wages and benefits in the private sector. Other items also contributed to the differences such as the high cost of protection and indemnity insurance versus the cost of coverage under the Federal Employee Compensation Act.

Although some commercial representatives believe that certain provisions of OMB Circular A-76 favor the Government, the differences due to crew costs are so large, we believe that merely changing some of the Circular's provisions and requiring more adjustments in the calculations are not likely to change the outcome of the comparisons.

Given the results of the A-76 studies completed to date, it appears that increasing the number of government-owned vessels operated by commercial firms would likely result in additional costs to the government. If it is decided, as a matter of policy, that such an increase is desirable to support the U.S. maritime industry, it is important that the additional costs be identified and disclosed rather than changing the circular's cost comparison process. Decision-makers can then make informed judgments about the funding amounts as well as the degree of support these funds provide.

Concerns with the Current System of Setting Cargo Rates for MSC Cargo

Many members of the merchant marine industry are concerned that the current system of cargo rates, used in MSC shipping agreements, is driving rates too low and carriers are not recovering their costs with obvious adverse effects on the industry. They stated the competition among U.S. flag ocean carriers for DOD export cargo, a major portion of the cargo available to them, is intense. The intensity of this competition is attributed primarily to the overcapacity of cargo space presently existing among U.S. flag carriers.

A number of modifications in the way MSC sets cargo rates have been suggested by members of the maritime industry. Basically, these changes would modify the rate setting process, assign cargo to experienced carriers who own their own ships, allocate cargo to more carriers, and reduce the percentage of cargo allocated to the lowest bidder. The proposals are intended to aid the U.S. flag carriers. MSC believes that the rates it is paying are compensatory and that the current practices are working well. MSC also notes that its practices assure a reasonable cost to the government, and sees no reason to change them.

The government is faced with two competing objectives: (1) obtaining the lowest cost possible and (2) maintaining a mobilization base. If changes are made, such as modifying the rate system in a manner that results in additional costs, we believe such additional costs should be identified and fully disclosed.

Use of Ready Reserve Force Ships

The RRF is a quick response, government-owned merchant ship reserve fleet maintained by the Maritime Administration (MARAD) for use by the Navy in the event of a mobilization or national emergency to transport military cargo. Ships from the RRF are periodically activated by MARAD for MSC and used to transport containerized, roll on/roll off, or break-bulk cargo in support of military exercises, as specified in a Memorandum of Agreement between the Navy and MARAD.

Some ocean carriers say RRF ships are being used in multiple military exercises for what they believe are extended periods of time (defined as over 60 days by the carriers) and are taking opportunities to carry cargo away from the U.S. flag merchant fleet. They also believe RRF ships, after being activated, were idle for long periods of time awaiting government retrograde cargo or cargo for the next exercise.

MSC acknowledges that RRF ships have been used for increasingly longer periods than in the past and participated in sequential exercises in an effort to save activation costs. It does not, at this time, foresee the need for extended activations in the future.

Beginning in the fall of 1987, MSC began concerted efforts to carry cargo for military exercises in commercial ships whenever possible. Our work disclosed that, from October 1, 1987, through July 15, 1988, six RRF ships were activated, only one of which was operational for longer than 60 days (75 days). This indicates that MSC is addressing the concerns raised by the carriers.

- - - -

In summary, Mr. Chairman, MSC's present methods of contracting for ship operation and maintenance and cargo rate setting focus on obtaining the least cost to the government, which is consistent with government procurement policy. If changes are to be made in order to support the U.S. maritime industry, which result in additional costs, it is important that these costs be identified and fully disclosed. Decision-makers will then be in a better position to make informed judgments about the cost and benefits associated with such a program.

This concludes my prepared remarks and I would be pleased to respond to any questions.

INDUSTRY CONCERNS REGARDING THE POLICIES AND PROCEDURES OF THE MILITARY SEALIFT COMMAND

PREPARED BY THE U.S. GENERAL ACCOUNTING OFFICE

August 9, 1988

PREFACE

At the request of the Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, the staff of the General Accounting Office (GAO) has gathered information on the positions and views of the Military Sealift Command (MSC) and representatives of the maritime industry concerning MSC's policies and procedures and their impact on the U.S. Merchant Marine. Industry representatives believe that these policies and procedures are adversely affecting the industry.

According to the Maritime Administration (MARAD), since 1970 the number of major U.S. flag liner companies operating in foreign trade has declined from 18 to only five companies. During this time the total number of ships operated by these companies has declined from 475 in 1970 to 105 today.

The purpose of this document is to present a summary of the information and views of both MSC and representatives of the maritime industry.

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ABBREVIATIONS

DOD	Department of Defense
FAR	Federal Acquisition Regulations
FMC	Federal Maritime Commission
GAO	General Accounting Office
MAC	Military Airlift Command
MARAD	Maritime Administration
MSC	Military Sealift Command
OMB	Office of Management and Budget
PWS	Performance Work Statement
RFP	Request for Proposals

USE OF COST COMPARISONS IN DETERMINING WHO OPERATES AND MAINTAINS MSC SHIPS

This appendix provides information regarding industry concerns with the practices and procedures of the Military Sealift Command (MSC) in making cost comparisons under the provisions of Office of Management and Budget (OMB) Circular A-76, and discusses MSC's position on these concerns.

BACKGROUND

The U.S. Merchant Marine is in a state of decline and relies on MSC for a significant portion of its business. MSC is the single manager operating agency for sealift services within the Department of Defense (DOD) and maintains a work force of nearly 4,000 civil service mariners to operate and maintain certain government-owned vessels. These ships include tankers and cargo vessels, as well as special projects ships such as oceanographic research, hospital, cable laying and repair, and range instrumentation ships. Since 1982 MSC has completed five cost comparisons under the provisions of OMB Circular A-76 to determine whether commercial firms or its own civil service mariners would provide the most economical operation and maintenance of these ships. The results of these cost comparisons are shown in table I.1.

Table I.1: Results of Cost Comparisons Under OMB Circular A-76

Ship type	Number of ships	Low commercial offer	MSC cost	Decision	Date of decision
Tanker	3	$44,915,290	$ 28,518,657	MSC	11-12-82
Oceanographic	12	89,985,701	114,789,090	Contract	12-12-85
Hospital	2	14,431,294	8,149,255	MSC	07-02-87
Cable	5	64,597,225	40,981,142	MSC	10-30-87
Range Instrumentation	5	52,119,072	33,218,449	MSC	03-08-88

Additionally, MSC is soliciting commercial proposals for the operation of seven tug boats and is preparing a solicitation for the operation of a cargo vessel.

All of the ships had been operated by MSC prior to the OMB Circular A-76 determinations, except the two hospital ships which were newly converted from former commercial tankers; and one of the range instrumentation ships, which had been operated with a Navy crew.

In the cost comparison for the oceanographic ships, the commercial offeror proposed to crew the ships with 77 fewer mariners than proposed by MSC (447 vs. 524), and included no overtime costs. Athough MSC's civil service wage rates were lower than the commercial rates, they were not low enough to overcome the disparity in manning and MSC's inclusion of overtime at historical levels ranging from about 54 percent to about 108 percent of the base wages.

In the cost comparisons which favored MSC, the largest differences were in crew costs, largely because of higher wages and benefits in the private sector. For instance, in one of the comparisons, the overall commercial personnel cost was 15 percent higher than MSC's and was more than 60 percent higher in some positions. Other factors, such as insurance costs, profit and cost of capital also played a part, but their elimination would not have been sufficient to overcome the differences in crew costs.

INDUSTRY CONCERNS WITH MSC ACTIONS IN OMB CIRCULAR A-76 DETERMINATIONS

Industry representatives have expressed a number of concerns with the way MSC participates in the OMB Circular A-76 process, as well as with MSC's administration of one contract awarded to a commercial offeror for the oceanographic ships. In the cases of the hospital, cable, and range instrumentation ships, commercial offerors filed bid protests with us questioning the decision of MSC to operate the ships using its own civil service mariners.

Representatives of commercial firms expressed the view that MSC's success in winning four of five OMB Circular A-76 cost comparisons is hastening the decline of the civilian merchant mariner work force. Some believe they cannot win competitions under these procedures and have said that they will not make offers on further solicitations. MSC believes that, since none of the ships in question were operated previously by commercial firms using

civilian mariners, the cost comparisons are actually offering the civilian merchant marine opportunities for expansion. Additionally, MSC said that the size of the merchant mariner work force is not necessarily affected since both MSC and commercial firms draw from the same finite pool of mariners.

Some commercial representatives believe that certain provisions of OMB Circular A-76 present an advantage to the government in determining the costs it will include in its proposal for comparison with a commercial offer. For instance, in determining personnel costs to be included as part of overhead, the government need only include the costs associated with direct supervisory positions one level higher than that activity under review, and administrative support positions which would be completely eliminated if the function were contracted out. Commercial offerors generally include a full proportionate share of their overhead burden in order to recover the costs of doing business.

Commercial offerors are required to carry large liability insurance policies to cover employee injuries and the risk of lawsuits for large judgments to compensate employees for mental anguish, pain, and suffering. They must therefore include in their offers the cost of large insurance premiums and provide for payment of large deductibles. The government's liability for employee injuries is limited by the Federal Employees Compensation Act. The circular,

therefore, only requires that the government include in its cost determinations an amount equal to .0007 of its personnel costs to cover liability for employee injuries.

On the other hand, certain provisions of the circular result in advantages for commercial offerors. For instance, the Federal Employee Retirement Act of 1986 requires that the government's retirement system costs include only contributions for the basic federal pension in preparing cost comparisons. The circular therefore requires that government and contractor Social Security and thrift plan contributions be excluded in cost comparisons. Since contractors pay social security for all employees and the government pays only for those covered by the new Federal Employee Retirement System, exclusion of these costs results in an advantage for commercial offerors.

Costs of MSC's Personnel Pool

MSC establishes the size of its civil service mariner work force at about 125 percent of the shipboard positions to be filled. The excess mariners provide a pool to ensure that all shipboard positions are filled at all times while allowing for normal non-productive activities such as leave, training, travel, discipline, sickness, etc. While many mariners in the pool are unavailable for ship assignment because of these activities, some are in a duty

status ashore awaiting assignment to a ship, and are paid whether they work or not. These factors affected MSC's proposal for hospital ships.

In its cost estimate for the operation of two hospital ships, MSC proposed to augment, as needed, the crews of each of the ships with three full-time equivalent members of the pool who were in a duty status awaiting assignment. The estimate did not include the salary and fringe benefits costs of these pool members because these members were already part of the pool earmarked for the operation of existing MSC ships, and these costs would continue regardless of who operated the new hospital ships.

The low commercial offeror appealed MSC's treatment of the costs of the pool members to the Office of the Chief of Naval Operations. The appeal questioned MSC's omission of these costs on the basis that the crews of the ships would actually be increased by an average of three members each, and the cost of those crew members, including salaries and fringe benefits, should have been included in MSC's proposal as direct personnel costs.

MSC reasoned that the hospital ships were a "new start" and its work force, including the pool, did not yet include personnel to crew the ships. Therefore, it planned to use existing pool members for the augmentation who would be paid whether they worked or not. MSC said the costs to be incurred to enlarge the pool in accordance

with the size of the crews of the new hospital ships were included in its cost estimate. However, its planned use of existing pool employees would not represent additional expenses incurred solely as a result of operating the hospital ships and should not be included in its estimate. The Office of the Chief of Naval Operations agreed and, in its decision on the appeal said that: "Use of the 'pool' is a distinct and inherent advantage of the government in preparing this T-AH (hospital ships) bid. MSC is allowed to use 'pool' mariners without costing their labor and fringe (sic)."

MSC told us that the cost estimate for the hospital ships included the pool costs that would be associated with the crews of the ships, following MSC's normal practice for these costs. MSC said pool costs fall into three categories to cover personnel on paid leave, in training, and awaiting assignment, and are calculated based on historical data. Leave costs are added to the crew's base wages as part of direct personnel costs, training costs are included in "specifically attributable costs," and a proportionate share of the cost of personnel awaiting assignment is included in the calculation of overhead costs.

MSC's treatment of these costs appears to comply with the requirements of OMB Circular A-76. Under the provisions of this circular, costs that would continue to be incurred regardless of who operates the ships are to be excluded from the cost estimate.

APPENDIX I

Revision of MSC's Proposal on Cable Ships

MSC solicited proposals for the operation and maintenance of five cable ships on April 21, 1986. Initial offers were received by MSC's contracting officer on or before the due date of September 19, 1986, and "best and final" commercial offers were received on August 7, 1987. In the interval between initial and best and final offers, MSC issued seven amendments to the request for proposals (RFP); and withdrew, revised, and resubmitted its own proposal. MSC's revision reduced its costs by about $5.7 million, or 12 percent. MSC stated the revisions were necessary because:

--amendments 9 through 12 significantly revised the performance work statement (PWS) by dividing the ships into two lots, changed the delivery dates and operating schedules, and required that a successful commercial offeror undergo government-furnished training; and
--inflation indices changed, and pay rates and required medicare contributions increased in the period since initial offers were due.

Industry representatives contended that none of the amendments to the RFP subsequent to receipt of initial proposals changed the PWS enough to require the extensive revisions MSC made to its cost estimate and that MSC was therefore in violation of Chief Naval Operations Instruction (OPNAVINST) 4860.7B, which provides:

"475. Revisions to PWS/(Most Efficient Organization) Prior to Bid Opening/Announcement of Results

A. Policy changes as well as evolutions occurring during the solicitation process frequently provide occasions for changes. The nature of the possible changes and nature of the solicitation itself affect the kind of changes which are permissible. The following guidance applies:

* * * * *

2. Negotiated Solicitations. Changes may be made to both the (Most Efficient Organization) and the Government estimate up to the date proposals are received. After this time, changes may be made only if amendments to the solicitation, during the negotiation process, change the performance requirements identified in the PWS. In such cases, the Government estimate should be withdrawn, revised to reflect the changed requirement, recertified by the reviewing official, and resubmitted to the contracting officer by the date established for the receipt of amended proposals. No other changes are permissible prior to the announcement of the results of the comparison.

(Underscoring added.)

MSC revised its estimate as necessary to conform to the RFP amendments. The revision also significantly reduced the amount of overtime pay expected during the contract period. The bases for the reduced overtime costs were (1) a new overtime study and (2) a new concept for in-port operations; both of which occurred after initial offers were received. The overtime study was used to reduce normal overtime both in-port and at sea, and the in-port operations concept allowed for different work rules to assign crew members to shifts, avoiding payment of overtime.

MSC states that it is required by both the circular and OPNAVINST 4860.7B to develop cost estimates based on the most efficient and cost-effective organization. It also states that the Secretary of Defense is required by section 502 of the 1981 Department of Defense Authorization Act (P.L. 96-342) to certify to the Congress that the government's cost estimate is based on the most efficient and cost-effective organization before converting a government-operated commercial-type function to a contractor operation. MSC believes it was, therefore, not simply authorized but required to extensively revise its cost estimate on the basis of the latest available information.

Based on information MSC provided, its revisions appear to have been more extensive than required merely to conform to the amendments of the RFP. OPNAVINST 4860.7B states that apart from revisions necessary to reflect changed performance requirements (the amendments of the RFP), no other changes are permitted in the government estimate prior to the announcement of the result of the cost comparison. MSC's revisions reduced the estimate by $2,111,663 to conform to amendments in the RFP and revised cost factors, and by another $3,595,720 for the overtime changes. MSC told us that its initial estimate of $47,663,565 was $5,645,392 lower than the low best-and-final commercial offer of $53,308,957. Therefore, the operation of the cable ships would have been retained in-house even if MSC had not revised its cost estimate.

The instruction appears to preclude revisions based on policy changes such as the in-port operations concept used by MSC to support some of its revisions for overtime costs. However, we also noted that section 502 of Public Law 96-342 has been incorporated in OPNAVINST 4860.7B. As a result, there is an apparent conflict within the instruction. On one hand, it requires naval activities to certify that their proposed costs are calculated on the basis of the most efficient and cost effective organization. On the other hand, it requires them to refrain from adjusting the cost calculations when ways to operate more efficiently surface after initial proposals are due. This conflict in the instruction should be resolved by the Navy.

In any event, once MSC recognized that its initial proposal did not reflect its most efficient and cost effective organization for operating the cable ships, its options were limited to cancelling the solicitation or revising its proposal. OMB Circular A-76 requires correction of the government proposal rather than cancellation of the solicitation. MSC considered cancellation and rejected that option, and we have no reason to believe it abused its discretion in this regard.

MSC Response to Offeror's Questions

An offeror on the cable ships solicitation complained that MSC did not respond in writing to its questions regarding the costs of government-provided training that would be added to the low

commercial offeror's proposal. The offeror said it is a normal contracting practice for the contracting agency to respond in writing to written questions from offerors when the answers would affect the offers or the agency's award decision.

MSC told us that it did not provide written answers to the offeror's questions because the training costs would be added only to the low commercial offer when comparing it to the MSC proposal. Determination of separate training costs for each commercial offeror would be time-consuming and premature, and would have no affect on selection of the low commercial offer.

We do not believe the offeror was prejudiced by MSC's failure to respond in writing because the requested information did not appear to be necessary in order for the offeror to submit its best and final offer.

Failure to Provide Clarifying Information to all Offerors

In its cost estimate for operation of the five cable ships, MSC proposed that an on-shore boiler be leased when the USNS Furman is in port during warm-weather months. This would allow shut-down of the ship's boilers, and result in a crew reduction.

A representative of MSC's comptroller office, who prepared the MSC cost estimate, said that the cost of leasing the on-shore boiler was excluded from MSC's estimate. She said amendment 12 to the RFP made a language change that allowed for direct reimbursement of those costs when ships are in-port in a "special reduced operating status." However, she was unsure if the revised language would allow for reimbursement of the costs or if they should be included in the estimate as an operating cost. She therefore verbally asked the contracting officer whether the costs were reimbursable and received a verbal reply in the affirmative. This information was not specifically communicated to commercial offerors, although it might have had an affect on their offers. Commercial offerors told us they were unaware that lease of an on-shore boiler was an option, feeling themselves constrained by a clause in the RFP that provided "there will be no leased equipment provided by the Government for the performance of this contract." MSC believes the commercial offerors had an equal opportunity to provide for lease of an on-shore boiler in this instance since the amended language was distributed to all potential offerors.

Amendment 12 was distributed to all offerors, and the amended language was to add ships in a "special reduced operating status" to those which would be provided shore power and shore steam at government expense. The USNS Furman was the only ship in the RFP to which the special status applied. Therefore we do not believe

that the other offerors were prejudiced by MSC's failure to direct their attention to the clear language of the solicitation. Additionally, it is not unreasonable for a contracting officer to consider formal clarification unnecessary when only one inquiry is made, and there is no problem readily apparent in the solicitation.

Administration of a Contract by MSC

The contractor operating the 12 oceanographic ships (now 11 due to one ship having been rammed while at anchor and subsequently removed from service rather than repaired) has made strong accusations about the way MSC administers the contract. It claims that, as a result, it cannot properly manage its activities, and has severe cash flow problems.

For instance, the contract contains an "off-hire" clause that allows MSC to withhold payment for each day a ship is unable to perform its mission when the contractor is at fault. The contractor contends that MSC places ships off-hire an excessive number of days for failure to perform, without sufficient investigation of causes. Of 345.9 unscheduled off-hire ship days imposed between July 15, 1986, and April 20, 1988, 202.5 ship days (59 percent) were reinstated for payment by MSC as of April 30, 1988. Since the end of January 1988, MSC has instituted a practice of placing a ship provisionally off-hire and allowing the contractor 30 days to provide justification before imposing

deductions. MSC's decision to delay the imposition of off-hire penalties appears to be a reasonable approach to resolving this situation.

PROPOSALS BY OTHERS TO MODIFY THE PRESENT SYSTEM

During our review, members of the U.S. Merchant Marine industry suggested revisions to the procedures established by the circular. The proposals are aimed at increasing the commercial operation of government-owned vessels by:

--Reducing the government's advantage by requiring that its proposals under the circular include a proportionate share of applicable overhead costs, including general and administrative expenses and an insurance adjustment; and

--Mandating commercial operations by eliminating use of the circular procedures for award of contracts to operate government-owned vessels, and conduct a competition among commercial firms only, which would limit MSC's operation of its ships to those exempted from commercial operation because of special considerations.

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Given the results of the OMB Circular A-76 studies completed to date, it appears that increasing the number of government-owned

vessels operated by commercial firms would result in additional costs. If it is decided, as a matter of policy, that such an increase is desirable to support the U.S. the maritime industry, it is important that the additional costs be identified and disclosed rather than changing the circular's cost comparison process.

 APPENDIX II

CURRENT SYSTEM OF SETTING CARGO RATES FOR MSC CARGO

This appendix outlines the concerns industry has with the cargo rate system that MSC uses. It discusses various industry proposals to modify the current practices and MSC's comments on these suggestions.

BACKGROUND

According to the Maritime Administration (MARAD), since 1970 the number of major U.S. flag liner companies operating in foreign trade has declined from 18, to only 5 companies. The total number of ships operated by these companies has declined from 475 in 1970 to 105 today. Also, the total dry cargo deadweight tonnage these ships can carry has declined during this period from 6,112,000 to 2,843,000 tons.

MSC is responsible for the ocean transportation of DOD sponsored cargo. To move this cargo, it uses chartered ships and contracts for space on commercial ships owned and operated by U.S. flag carriers. Contracting for ocean transportation services is done primarily through shipping agreements for containerized and break-bulk cargo. Every 6 months, carriers submit bids offering a fixed price per ton of military cargo for each of the major shipping

routes. Cargo rates, terms, and conditions are determined in accordance with the Armed Services Procurement Act, the Competition in Contracting Act, and the FAR.

Under the current system, MSC awards the lowest bidder up to 75 percent of the cargo to be carried on a designated route, while the remainder of the cargo is carried by the next lowest bidder(s). The percentage of cargo awarded to a particular bidder depends upon the trade route and the number of bidders. MSC also uses tariffs in trade routes which are not covered by shipping agreements. These tariffs are filed by ocean carriers with the Federal Maritime Commission (FMC) and are used by both MSC and commercial carriers.

CONCERNS WITH THE CURRENT SYSTEM

Some members of the merchant marine industry claim that the current system of MSC cargo rates is weakening an already weak industry. Among the reasons cited are the intense competition among U.S. flag ocean carriers for DOD export cargo which is a major portion of the export cargo available to them. The intensity of this competition is being attributed to an overcapacity of export cargo space currently existing among U.S. flag carriers.

APPENDIX II

In the Second Report of the Commission on Merchant Marine and Defense, dated December 30, 1987, the Commission expressed particular concern about the adverse effects of current contracting practices upon the operators of commercial ships. They said that in order to carry DOD cargo, some ship operators have submitted low bids that may have contributed to their financial failure.

A number of U.S. ocean carriers believe that the current system of shipping agreements (cargo rates) used by MSC is driving rates too low and that carriers are not recovering their costs; this view also is shared by some maritime unions.

Since DOD is the country's largest shipper of export general cargo, its cargo is essential to U.S. carriers importing from abroad. Some industry officials stated that the competition for DOD cargo has forced some ocean carriers to submit bids below their fully distributed costs, noting that a U.S. flag carrier cannot stay in business unless it carries DOD cargo. Carriers engaged in foreign trade must offer a regularly scheduled service between fixed points in order to remain competitive in foreign trade. These carriers believe it is better to carry some cargo at rates below cost rather than to sail half full, and this drives some carriers to bid below costs.

MSC believes the Navy's procurement system is fully consistent with the Shipping Act of 1984's philosophy of replacing government regulation with competitive forces of the marketplace. It cites the following regarding the Navy's procurement system for ocean transportation.

--Ocean transportation, similar to other services, is procured on the basis of full and open competition in compliance with the Competition in Contracting Act. The only modification to this fully competitive policy is in the case of DOD cargoes where a limit on the maximum percentage of cargo has been imposed on a carrier for some major routes. This conforms to Navy policy to ensure the long-term viability of at least two companies on those routes so that competition can always be maintained.

--To the extent possible, the government should do business in the same manner as other commercial users of ocean carrier services. Commercial shippers pay the market rate based on (1) conditions of supply and demand and (2) fluctuations in the rate of foreign exchange.

--Pursuant to section 101 of the Merchant Marine Act of 1936 (46 U.S.C. 1101), MARAD is responsible for promoting the U.S. Merchant Marine. MARAD provides subsidies to offset higher U.S. wages and costs so U.S. flag carriers may remain competitive in the international market. In addition, various cargo

preference laws provide advantages to these carriers over foreign competitors in the carriage of DOD cargoes outbound to help balance their voyages.

--MSC uses commercial carriers to move all of its military cargo. There are no government-owned dry or liquid cargo ships in MSC's fleet engaged in point-to-point service. More than 80 percent of DOD dry cargo tonnage is moved on commercial liner ships annually. The remainder is moved in U.S. commercially chartered vessels.

OPINIONS ON VARIOUS MSC PRACTICES AND PROCEDURES

During our review, we obtained opinions on various aspects of MSC's cargo rate system from industry sources who proposed changes to MSC's cargo rate system. We also attempted to obtain the position of the United Shipowners of America regarding these proposals. However, since its members were exploring various alternatives to the present system at the time of our review, United Shipowners of America officials concluded that a firm position on any alternative would be premature and may not be in the best interest of all of its members.

Changes to Length of Cargo-Rate Cycle

Some individuals representing the U.S. maritime industry believe increasing the 6-month cargo rate contract cycle to 1 year would

provide more stability in the system. There is no industry consensus, however, on this proposal.

In 1971, MSC shortened the cycle from 1 year to 6 months in response to comments from the carriers that the cycle was too long. MSC believes that the 6-month cycle continues to offer several advantages, to both carriers and the government. According to MSC, this 6-month cycle (1) enhances competition by permitting periodic adjustments in rates to meet changing world economic conditions, as well as domestic and international trade conditions, (2) provides greater flexibility to carriers for adjustments in operating and maritime cost factors, shifts in the balance of trade, and other changing world competitive conditions, and (3) gives carriers the opportunity to improve their competitive position.

Changes in Percentage Allocation to Lowest Bidders

One carrier believes the current military procurement system pits carriers in a life and death struggle to be the number one carrier, because it offers 75 percent of the military cargo to the number one carrier. This carrier proposes that the carrier offering the lowest rate on a trade route with more than two bidders get less than 75 percent; this might be accomplished by the "me too" process in bidding which would ensure that other carriers have an opportunity to participate at the winning carrier's rates. For example, if three or more carriers were bidding on a trade

route, the carrier offering the lowest rate would automatically get first call on 50 percent of the cargo and the remaining carriers would split the other 50 percent, provided they agreed to accept the winning carrier's rates. The carrier believes this preserves the competitive incentive and also provides a share of cargo for all carriers and protects the government from paying higher rates to carriers that are seeking only a small portion of military cargo as is sometimes the case.

MSC believes this proposal would violate existing statutory requirements for full and open competition. Specifically, it is concerned that carriers would not have an incentive to offer their best rates, as each would be assured of a substantial volume of cargo regardless of the rate. As a result, each carrier would bid high, increasing the government's transportation costs significantly. MSC also believes the proposal is overly simplistic in that it assumes that all carriers are equal in terms of service and capacity. It also notes that if one of three carriers bidding on a route could carry only 30 percent of the cargo and the next as much as 50 percent, there is actually an incentive for each carrier to bid as high as possible.

Elimination of Best and Final Offers

This same carrier also believes that the current practice of asking for best and final offers as part of the cargo rate contract

process should be eliminated and rates should be filed at one time as close as possible to the end of the current cycle. The carrier believes that asking for best and final offers gives bidders too much opportunity to find out what the other original bids are and that a single bid system would eliminate any suspicion of such leaks.

MSC's position is that a negotiated procurement (the present cargo rate contract process which includes asking for best and final offers) and the single bid process (sealed bidding), alluded to above, are significantly different procurement processes. MSC believes the essential element that makes a sealed bidding process inappropriate for the procurement of ocean transportation services is the lack of flexibility and discretion afforded a contracting officer to exercise business judgement in making an award.

In support of its position, MSC cites the following:

--In sealed bidding, MSC would be required by the FAR to reject an offer that fails to conform to the essential requirements of the solicitation. It is immaterial whether the nonconformity occurred by design or mistake, or whether the bidder is willing to modify the bid.

--The FAR requires a contracting officer to make an affirmative finding of responsibility before awarding a contract. In sealed bidding, questions of responsibility are determined primarily on

the basis of all the information submitted or available, up to the time of award. Under a negotiated procurement, a contracting officer can advise, during discussions, all offerors of the standards that each must meet to permit an affirmative finding of responsibility prior to award.

--In sealed bidding, a contracting officer cannot discuss the level of rates offered. This denies a carrier the opportunity to reconsider and modify its rates in a best and final offer.

Fulfillment of Bidders' Obligations

Some in the maritime industry believe that the submission of a bid should carry with it an obligation to carry cargo if the bidder is successful and that MSC should require evidence of a bidder's ability to fulfill its obligations before allowing it to bid. (Under the current system, new carriers are not required to establish a record of operating experience in commercial trade for a period of time as a precondition for bidding.) Some industry officials suggest that in order to bid, a company should have 6-months experience, own at least one ship that meets Navy standards, and be capitalized with at least 50 percent U.S.-owned stock. They believe this would be fair to experienced commercial carriers because under the current system, to be eligible to carry government cargo, a carrier must commit its transportation assets to the Sealift Readiness Program, which is designed to be activated in peacetime to meet contingency or less-than-full mobilization requirements.

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MSC states it reviews all offers, from common carriers and contract carriers, including those submitted by "new entrants" to determine whether they have the necessary U.S. flag ships, equipment (or the ability to obtain the same in time for contract performance), and the management expertise to perform the contract. It further states the contracting officer relies on demonstrated experience by individuals in a company to ensure the company's ability to perform. It also believe requirements for vessel ownership would negate a company utilizing bareboat[1] or time chartered ships, a common practice in the industry. Furthermore there is no statutory authority requiring unsubsidized carriers to maintain service (carriers receiving operating differential subsidies do incur contractual obligations to provide certain levels of service). In summary, MSC believes the suggested requirements that (1) a company have a prior period of experience, (2) own a vessel, and (3) be capitalized with at least 50 percent U.S.-owned stock would restrain competition rather than improve the efficiency, quality of service, or economy in the U.S. Merchant Marine.

PROPOSALS BY OTHERS TO MODIFY THE PRESENT SYSTEM

The Commission on Merchant Marine and Defense recommended that DOD, in conjunction with FMC and MARAD, change the method of solicitation for procurement of ocean transportation services to a

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1 A ship charter agreement whereby the charterer provides for all operating expenses, including crew, fuel, and maintenance.

stable rate system that is based on the established tariff rates used for commercial shippers. The Commission believes this recommendation would:

--"Provide stability to the merchant marine industry;
--Provide sealift capability to meet mobilization requirements;
--Provide ship operators with rates that more accurately reflect fully distributed costs and provide reasonable rates of return on investment;
--Provide the Department of Defense with comparable and equitable shipping rates available from more than one carrier on the same route;
--Stabilize shipping rates for a longer period of time;
--Encourage U.S. flag carriers efforts to upgrade to new ships and equipment that increase productivity and meet military as well as commercial requirements; and
--Prevent the unsatisfactory service that may result when unproven or speculative carriers 'buy-in'."

MSC does not agree with the Commission's recommendation because it believes rates offered by the carriers in a full and open competition reflect the conditions of the marketplace and, at a minimum, cover the carriers' incremental costs. Thus, it believes use of the recommended tariff system would result in higher costs to DOD from commercial shippers for equivalent services. MSC further states that, at a FMC-sponsored industry conference held

from February 18 to 19, 1988, senior officials of the major U.S. flag carriers and of two major foreign flag carriers, as well as academicians, attributed industry's problems to overcapacity on major routes encouraged by banks, shipyards, foreign governments, and the imbalance of trade. According to MSC, these officials did not include DOD procurement policies, practices, and rates as factors in the industry's decline.

Adoption of a Cargo Rate Program Similar to that of the Military Airlift Command

Some in the merchant marine industry propose adopting a program similar to the one currently being used by the Military Airlift Command (MAC) in the transportation of government cargo by commercial airlines. Under this program, all participating air carriers supply MAC with fully distributed cost data. Using this information, MAC calculates a composite rate based on the costs of all participating carriers and weighted by the percentage of total lift capacity offered by each. MAC then applies a profit factor of about 15 percent. Once the rate per ton mile is computed it is used for all types of planes worldwide.

To participate in the program, a carrier must be qualified through experience and by passing a financial responsibility test. Only U.S. flag aircraft owned by a carrier can participate. The allocation of cargo for each participating carrier is based on the ratio of the cargo-carrying capacity of each participant to the total capacity committed by all participants.

Advocates of the use of a system similar to MAC's for the U.S. maritime industry suggest that such a system (1) provides a fair and reasonable return on investment for air carriers, (2) assures a government cargo rate that is below the commercial rate, and (3) provides essential government support for a defense mobilization asset.

MSC states that, although it and MAC both procure transportation services, basic differences exist in requirements and procedures used by each Command for procuring space for the transportation of their cargoes.

Under the current cargo rate process, MSC awards contracts, similar to a requirements contract, to all technically acceptable and responsible carriers that offer rates; as a condition for award, carriers are required to agree to commit half of their ships to the Navy's Sealift Readiness Program. As ocean shipping requirements arise, cargo is booked, in descending order of cost to the government, to the carrier that best meets the specific requirements at the least cost. Similar to the Navy program, MAC, through its Civil Reserve Air Fleet program, allocates its cargo in exchange for a carrier commitment of airplanes to be called up by DOD. Most airlines use the same types of aircraft, the large passenger types, most needed by MAC in a crisis. Conversely,

according to MSC, the most efficient commercial ships are large non-self-sustaining container ships, which are the least military useful ships in a crisis.

MSC states there are other significant differences between Navy and MAC methodologies and practices which illustrate the fact that MAC's system is not applicable for the procurement of DOD ocean transportation services.

--Most of MSC's cargo is transported in less than shipload lots and is of a continuous regular nature ideally suited for the regularly scheduled service offered by U.S. flag ocean carriers.
--MAC meets its cargo requirements by using either Air Force owned aircraft or charters of entire aircraft for short periods. Scheduled airlines frequently have the ability to make their aircraft available for these short term charters, which can be accomplished in a day or two, whereas regularly scheduled ocean carriers do not have that flexibility. Accordingly, MSC operates a small number of U.S. flag time-chartered commercial dry cargo ships, contracted for under full and open competition, to provide this capability which is not available from commercial operators. Short-term voyage/spot charters for ocean movement of dry cargo are rare.

--MAC establishes rates using the ratemaking principles formerly used by the Civil Aeronautics Board. There is purposely no provision for governmental setting of rates in the foreign ocean commerce of the United States.

Furthermore, MSC states that during 1971-72, the "Sealift Procurement and National Security Study" was issued by senior members and staff of the OMB, DOD, MARAD, and FMC and industry representatives in response to allegations that DOD's procurement system had forced ocean carriers to offer rates below costs. The study found that, overall, DOD cargo rates were compensatory. MSC advised us that subsequently, the FMC performed numerous investigations of the rates charged for carrying DOD cargo to determine if such rates were too low under the standards of the Shipping Act of 1916. No rates were ever found to be noncompensatory and rates were never disapproved. In summary, MSC believes that any analysis of the applicability of the MAC's system to MSC involves complex issues and quick answers may well cause problems.

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The government is faced with two competing objectives: (1) obtaining the lowest cost possible for the government; and (2) maintaining a mobilization base. If changes are made to aid the

maritime industry such as modifying the rate system in a manner which results in additional costs, we believe such additional costs should be identified and fully disclosed.

USE OF READY RESERVE FORCE SHIPS

This appendix discusses the concerns voiced by various ocean carriers regarding the use of Ready Reserve Force (RRF) ships by MSC for extended periods of time during military exercises.

BACKGROUND

The RRF is a quick response, government-owned merchant ship reserve fleet that MARAD maintains for use by the Navy in the event of a mobilization or national emergency to transport military cargo. RRF ships are periodically activated by MARAD for MSC and are used to transport containerized, roll on/roll off, or break-bulk cargo in support of military exercises.

OCEAN CARRIER'S CONCERNS

Some ocean carriers stated they believe that RRF ships used in multiple military exercises for extended periods of time (defined as over 60 days by the carriers) are taking cargo carrying opportunities away from the U.S. flag merchant fleet. They also believe RRF ships were placed in a reduced operating status, in which they were idle for long periods of time awaiting government retrograde cargo or cargo for the next exercise.

Our review showed that from 1980 through July 15, 1988, there were 19 of a total of ~~46~~ 42 * activations of RRF ships in which the ships remained in operational use for 60 days or more. The periods of

* per Jos. Walsh, GAO 9/26/88

operational use for these ships ranged from 62 to 342 days; 13 ships under 100 days, 3 ships 100-150 days and 3 ships 150-342 days. The majority of ships were used in one exercise each; however, five ships were involved in multiple exercises with one ship serving in six exercises.

We also found that 4 ships of the 19 activated over 60 days were in a reduced operating status for periods ranging from 11 days to 143 days of their operational use. Of these four ships, two were in a reduced operating status for 25 days or less. The remaining two were idle for 85 days of an operating period of 174 days, and 143 days of an operating period of 342 days.

MSC believes that carrying military cargo on RRF ships during military exercises is a valid use of RRF ships. MSC acknowledges that RRF ships have been used for increasingly longer periods than in the past and have participated in sequential exercises in an effort to realize activation cost savings.

Beginning in the fall of 1987, MSC began concerted efforts to carry exercise cargo in commercial ships whenever possible. Our work disclosed from October 1, 1987, through July 15, 1988, six RRF ships had been activated, only one of which had been operational for longer than 60 days (75 days). This indicates that MSC is addressing the concerns raised by the carriers.

PREPARED STATEMENT OF VICE ADMIRAL WALTER T. PIOTTI, JR., COMMANDER, MILITARY SEALIFT COMMAND, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE ON AUGUST 9, 1988

Mr. Chairman, members of the Subcommittee on Merchant Marine of the House Committee on Merchant Marine and Fisheries. I am pleased to be here and welcome this opportunity to discuss policies and procedures of the Military Sealift Command pertaining to procurement practices for strategic sealift and our activities in response to the national policy on achieving economy and enhancing productivity promulgated by the Office of Management and Budget Circular No. A-76.

To fully understand these policies and procedures it is essential to understand the mission of the Military Sealift Command and its resultant relationship with the U.S. maritime industry. MSC is assigned as the single manager operating agency for ocean transportation (sealift) within the Department of Defense. To carry out its missions MSC is dependent on a healthy, efficient and balanced U.S. maritime industry--ships, people and industrial facilities--being readily available.

In addition to its sealift mission, MSC has two service unique missions--direct fleet support and special mission support. MSC's Naval Fleet Auxiliary Force of 39 ships provides direct fleet support to Navy combat ships at sea, replenishing fuel, ammunition, food, supplies and spare parts and providing towing services and ocean surveillance. MSC's Special Mission Support Force includes 22 ocean survey, research, cable and other ships in support of a diverse variety of worldwide Department of Defense operations.

It is MSC's sealift mission--the transportation of cargo--which is most closely related to and dependent on a competitive U.S. maritime industry. MSC is responsible for moving the vast majority of all materiel and supplies required by our armed forces in peace and war. More than 95 percent of the dry cargo and 99 percent of petroleum, oil and lubricants required to support our forces must be carried by sea on merchant type ships.

In March of 1984, the importance of this function to the nation's defense strategy received official recognition when the Secretary of Navy incorporated strategic sealift as the third function of the Navy, joining the long-standing dual functions of sea control and power projection.

Strategic sealift requires the capacity to deploy and sustain military forces whenever and wherever needed--as rapidly and for as long as operational requirements dictate. It is neither feasible nor desirable for the Navy to maintain an organic fleet of ships and related intermodal equipment sufficient to meet our peacetime requirements, much less the national strategy wartime requirements. All peacetime requirements can and are being met through services procured commercially from the U.S. merchant marine. Thus the interests of the U.S. Navy are inextricably tied to the U.S. merchant marine.

Conversely, in this period of its decline, the interests of the U.S. merchant marine have been tied to the U.S. Navy. At present, with its commercial shipping and industrial bases depressed, the

U.S. maritime industry has had to rely heavily on the government for its economic viability. The Departments of Defense and Navy have consistently provided the maritime industry with substantial profitable business without which the industry's economic condition would have been more acute.

The significance of Department of Defense and U.S. Navy contributions to the vitality of the U.S. maritime industry is best conveyed in the following discussion. The heavy marine industrial base of the United States, both privately and publicly owned, has executed an annual shipbuilding program for the U.S. Navy that for the last six years has averaged $11.9 billion per year, along with an annual modernization program of $1.2 billion and an annual repair and maintenance program of $3.5 billion for a total of well over $16 billion annually. All Navy shipbuilding and more than 30 percent of the repair and modernization are performed in the private sector. Thus the private sector was the beneficiary of 81 percent of the Navy's total for shipbuilding, repair and modernization, amounting to over $12 billion annually.

In addition to Navy's shipbuilding, conversion and repair programs, the maritime industry benefits significantly from Navy sealift operations. For the Fiscal Year 1982-1989, the Military Sealift Command will have spent over $5 billion for charter and contract-operated ships, such as Maritime Prepositioning Ships, Afloat Prepositioning Ships, Fast Sealift Ships, as well as the Ready Reserve Force; another $4.2 billion for shipping agreement

contracts for breakbulk and container services and for berth term shipments. Another $2.6 billion will be spent for the procurement of Sealift Enhancement Features and other amphibious equipment and for the operation and maintenance of contingency sealift ships. This adds to a total of approximately $12 billion over the FY 82-89 period for services rendered by the U.S. maritime industry.

The strategic sealift contingency programs were initiated by the U.S. Navy as stopgap measures to provide for national security during the decline of the U.S. flag merchant marine assets. These programs are not the final solution, nor the best solution. A healthy and competitive U.S. merchant marine capable of meeting the nation's economic and military maritime requirements at all times, but particularly during national emergencies, would clearly be a more desirable solution.

While these dollar figures are significant, cargo tonnage figures also are important, in that they show the Department of Defense to be an important customer of the U.S. flag merchant marine shipping company in its day-to-day operations. In FY 87, MSC shipped more than 9 million measurement tons of dry cargo in privately owned U.S. flag commercial ships, either under charter to MSC or under agreements or contracts. A very small 266,000 measurement tons of cargo was carried by government owned ships during the last year solely as exercise cargo, which in our opinion has in no instance placed the government in competition with U.S. commercial industry.

U.S. flag ships carried 14 million long tons of cargo in

regularly scheduled liner service during the calendar year 1987. Of that total, DOD cargo, excluding domestic trades, represented 2 million long tons--14 percent of the total. On the U.S. East Coast to Europe route--the largest of the U.S. trade routes--DOD cargo accounts for 50 percent of the total U.S. flag liner capacity.

Of relevance, U.S. flag liner carriage has increased in recent years. From January 1970 to June 1988, the number of U.S. flag, privately owned cargo ships declined from 893 to 410, a decline of 54 percent. However, due to more productive ships--ships having greater size, higher speed and improved cargo handling capability --the carrying capacity, or deadweight, actually increased by 28 percent--from 15.8 million DWT to 20.2 million DWT.

The most significant reduction in ship numbers was in bulk dry cargo ships, which declined from 568 to 178, with a reduction in carrying capacity of 37 percent. This was balanced by increased productivity. In 1970, U.S. flag liner ships carried 11.8 million tons of U.S. oceanborne foreign trade, equating to 23.5 percent of the total of 50.4 million tons. In 1986, U.S. flag ships carried 14.3 million tons, a 21 percent increase over 1970. This unfortunately represented only a 19.9 percent market share of the total of 71.8 million tons. In summary, U.S. carriers now carry 21 percent more cargo than in 1970, but have a 3.6 percent smaller market share of the U.S. liner trade. This reflects the need for U.S. flag operators to compete more aggressively against foreign carriers to regain the market share once held.

MSC exercises close oversight of the 1904 Cargo Preference Act. Foreign flag ships are rarely used and then, only with the personal approval of the MSC commander, when no U.S. flag ships are available or available U.S. flag ships cannot meet the operational required delivery date. More than 97 percent of dry cargo and more than 92 percent of petroleum products shipped by the Department of Defense in FY 87 moved in U.S. flag ships.

MSC is required by law, under the Armed Services Procurement Act, as amended by the Competition in Contracting Act (CICA), to obtain all goods and services through full and open competition, with very limited exception. As with other government agencies, MSC is a steward of the taxpayers' money and has a prime obligation to expend that money in the most cost effective manner.

A brief background of DOD's acquisition of services from ocean carriers will assist in placing the issues before this Subcommittee in perspective. After the Military Sea Transportation Service was established in 1949 (the name was changed to Military Sealift Command in 1970), cargo was allocated among the carriers under a uniform cost-base rate structure.

In 1954, U.S. carriers formed two organizations to exclusively interface with MSTS on their behalf, the Atlantic and Gulf American Flag Berth Operators (AGAFBO) and West Coast American Flag Berth Operators (WCAFBO). In effect, this action permitted carriers to charge DOD rates that guaranteed a profit to even the least efficient carrier. In the early 1960s Congressional concern with

rates charged DOD as compared to commercial shippers led to several cost comparison rate studies. It was a result of these studies that in February 1965 MSC requested rate reductions of 30 percent on general cargo. Coincidentally, at about this time, Sapphire Steamship Lines, Inc., initiated service on the North Atlantic and offered to carry DOD cargo under Government Bills of Lading at rates substantially lower than rates charged by AGAFBO.

After DOD announced its intention to begin shipping cargo with Sapphire, the AGAFBO carriers lowered their rates by as much as 60 percent, thus precipitating a "rate war" which lasted about one year and drove Sapphire into bankruptcy. Subsequently, the Federal Maritime Commission (FMC) launched an in-depth investigation into carrier practices relative to carriage of DOD cargo. FMC found that AGAFBO's reduced rates were unlawful and that in establishing those rates, AGAFBO had unlawfully attempted to compete unfairly with Sapphire. In a separate opinion, FMC Chairman Harllee and Commissioner Barrett stated:

"The various AGAFBO activities lead to but one conclusion, that the carriers agreed to take whatever steps were necessary to drive Sapphire from the trade. The cumulative effect of all these acts was decidedly one to destroy competition; that is, to end the threat of Sapphire and preserve the monopoly of AGAFBO."

An antitrust suit by Sapphire's trustee in bankruptcy was later settled by payment of a substantial sum. Certain carriers were subsequently forced to repay operating differential subsidy to the

Maritime Administration.

In 1966, DOD commenced rate system reforms which constitute the current system of competitive procurement for ocean transportation services.

Beginning with Fiscal Year 1967 procurements, DOD sought annual proposals from interested shipping lines which guaranteed a minimum amount of carriage on fixed trade routes. Since that time awards have been made on the basis of service, management expertise, offeror responsiveness, and cost, with the objective of fostering efficiency, quality of service and economy. Under this program, individual steamship lines compete for DOD traffic on the basis of their own individual costs and pursuant to their own individual management decisions. They have definite knowledge of the minimum amount of DOD traffic that they can expect during the period and are able to plan their commercial operations accordingly.

The Commission on Merchant Marine & Defense included among its recommendations a revision of MSC's liner procurement policy to a "rate system based on established tariff rates for commercial shippers." The president of the United Shipowners of America (USA) in testimony before the Commission in May stated that the current system for solicitation of DOD cargo is "an extremely complex issue and quick answers may well cause more problems than already exist." In July, again before the commission, the USA president stated, "Implementation of such a procedure will require thorough analysis since many complex questions must be addressed," and that in the

interim USA preferred to continue with a "modified version of the existing bid system."

In response to the important questions raised by the commission's report regarding the possible impact of MSC's competitive procurement policies on national sealift readiness, MSC tasked Harbridge House, Inc., to conduct an independent analysis of the current system and to evaluate the possible impact of implementing changes suggested by the commission and parties testifying before the commission.

The conclusions of Harbridge House's report indicates that the rates paid by DOD for liner services appear to be consistent with negotiated commercial rates paid by large shippers using service contracts permitted by the 1984 Shipping Act. In addition, the Harbridge House report indicated that the adoption of a system that required DOD to pay tariff rates would result in substantially higher costs. The report further indicated that on some trade routes tariffs appear to be little more than "paper rates" with virtually all traffic moving via (lower priced) service contracts. Thus, establishment of MSC rates based on filed tariffs would result in DOD's paying rates higher than those paid by commercial shippers. Finally, Harbridge House concluded that it is unlikely that an increase in U.S. liner revenues from the carriage of DOD cargo would increase the number of militarily useful ships in the commercial fleet. The types of ships which DOD will want most in an emergency, such as breakbulk ships, are the least efficient commercial ships.

Conversely, the most efficient commercial ships are large non self-sustaining container ships, which are the least militarily useful ships.

Some industry officials suggest that in order to bid, a company should have six months experience, own at least one ship meeting Navy standards, and be capitalized with at least 75 percent U.S.-owned stock. Requirements for vessel ownership would negate a company's utilization of bareboat or time chartered ships, albeit such arrangements are common in the industry. The suggested requirements that (1) a company have a prior period of experience, (2) own a vessel, and (3) be capitalized with at least 75 percent U.S.-owned stock appear to have a primary objective of restraining competition to existing companies rather than improving efficiency, quality of service, or economy in the U.S. merchant marine. It must be noted these requirements go well beyond the current eligibility requirements for government guarantees under Title XI of the 1936 Act.

Of the two primary competitive procedures specified in the CICA to accomplish full and open competition, MSC uses the Requests for Proposal (RFP), or negotiation process, to obtain ocean and intermodal transportation services for DOD cargo from common carrier liner operators or contract carriers able to provide liner type services.

Because of the complex nature of ocean transportation, the RFP procurement method is more efficient, more cost-effective for the

government and more advantageous to shipping companies than the alternative sealed bid procedure, or Invitation for Bids. The RFP process gives DOD a better opportunity of receiving the transportation services it needs at the lowest cost to the taxpayer and provides the most equitable procedure for all carriers. The RFP procedure guarantees all companies an equal opportunity in obtaining MSC contracts, while at the same time fostering the full and open competition called for by the Competition in Contracting Act.

Commercial ocean rates fluctuate in relation to market forces, including such independent factors as the relative strength of the dollar and the resulting level of exports; changes in tonnage capacity on particular routes; and operating costs, including fuel. Accordingly, and in fairness to the carriers, in 1971 MSC shortened the effective period of rates from one year to six months. This change received strong industry support.

To illustrate how market forces affect shipping rates, I have provided two charts that show the rate fluctuations that have taken place on two major Department of Defense shipping routes in the Pacific and Atlantic trades during the period from 1979 to the present. Eighty (80) percent of DOD liner cargo moves on these routes.

The first chart shows the Pacific trade, specifically, the U.S. West Coast to Japan, and demonstrates the classic relationship between competition and MSC rates. During the period when the MSC-carrier agreement rate decreased, three carriers operated in

this trade. During the periods of rate increases, only two carriers provided service. Additionally, the relationships among other market forces demonstrated predictable trends. For example, when the U.S. dollar weakened in foreign markets, export tonnages increased as did cargo rates.

Chart 2 shows the Atlantic trade, U.S. East Coast to Northern Europe. The chart indicates that from 1979 to 1981, when two carriers were in operation, rates increased; in 1982-1984, with three carriers in competition, the rates decreased. During this time exports were weak and the liner trade was overtonnaged, but it was also clear that there was an effort to eliminate the new U.S. entrants in the trade. From 1985 to 1986, when two carriers were in operation rates again increased, and subsequently began to stabilize.

From 1986 to the present, with four carriers operating, rates did not decrease as one would expect but increased, when the trade was dominated by one carrier. Increased capacities and more frequent sailings, combined with the limited capacities of the other three carriers, allowed the dominant carrier to ignore the competition in the setting of its rates. Also, as in the Pacific trades, the U.S. dollar caused export tonnage and cargo rates to increase dramatically.

The Military Sealift Command is affected by the same market forces as any other ocean shipper. The combination of currency, exports and operating cost fluctuations, together with competition,

changes in capacity, and demand, in turn determine each shipper's rates for cargo on a particular route.

This is as it should be. Competition is the bedrock of the American economic system, and has provided the American people with a standard of living and capability far superior to nations using other economic systems. Competitive procurement is our federal government policy and is the basis for all government purchasing. Competition has brought significant savings to the taxpayer, sharpened the cost effective consciousness of contractors and has resulted in contractor investments in ways that will lead to a strengthened industrial base and a stronger and more affordable national defense.

Turning to the matter of contracting for the efficient operation of government-owned or bareboat chartered ships, in 1983, the Navy identified 30 MSC ships then operated with civil service crews as having potential for commercial operation. Accordingly, MSC subsequently began a series of cost comparisons of those ships pursuant to OMB Circular A-76. The OMB circular states that this form of competition would enhance quality, productivity and economy. It further states that the policy of the federal government is to foster commercial activities and the government shall not start or carry on any activity to provide a commercial product or service if the product or service can be procured more economically from a commercial source.

MSC has to date conducted A-76 efficiency studies on the

operation of 24 ships operated with civil service mariner crews. Twelve of those ships have subsequently been turned over to commercial contract operation, while 12 have remained as civil service operated ships. Actual savings, plus avoidance of additional costs, totaling $115 million have been realized since FY 85 as a result of these efforts. MSC's objective is to provide the most efficient operation, while at the same time giving the private sector full and open opportunity to compete for these services. The A-76 methodology and the government cost estimates have been thoroughly reviewed by the Navy Audit Service, the Chief of Naval Operations during the appeal process for the cost comparisons, and the Government Accounting Office when these cost comparisons became the subject of protests. The MSC methodology and cost savings have been accepted by all three bodies.

The Navy has also been conducting a comprehensive cost-reduction program in accordance with the Presidential initiative to increase productivity throughout the federal government by 20 percent. The Department of the Navy initiative was designated ACTION '88 for "Attack Costs Through Improvement in Our Navy/Marine Corps." MSC initiatives within this program are aimed at streamlining ship operations, maintenance and repair to obtain quality services while balancing cost-effective requirements with readiness.

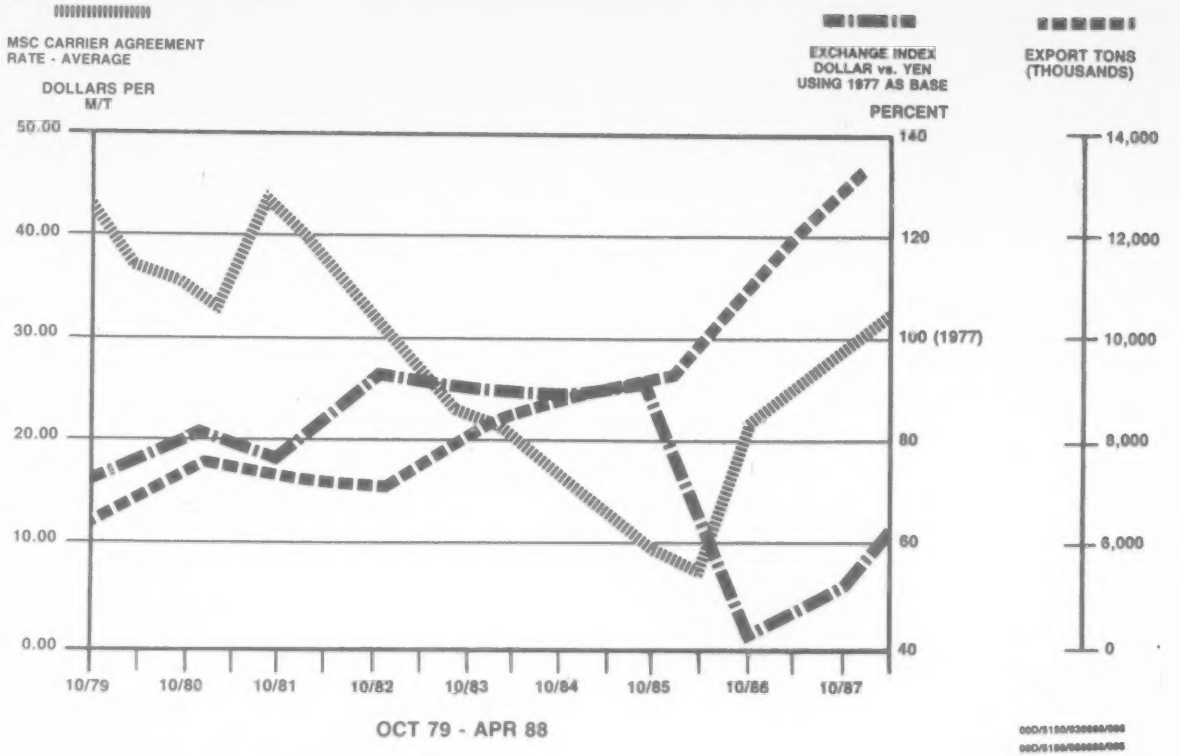
Mr. Chairman, the Department of the Navy fully supports the interest of the Congress in solving the problems of the maritime

industry, and we have participated earnestly and significantly in many areas to help formulate resolution of these problems.

MSC will continue to work with the Congress and the maritime industry in whatever way we can to achieve the common goal we all seek--a U.S. maritime industry capable of meeting all of the nation's economic and military needs.

The Department of Defense feels strongly its obligation to help support the U.S. maritime industry while at once obtaining the commercial transportation services it requires in the most cost effective manner. It believes just as strongly that its procurement of ocean transportation is consistent with that national procurement policy which fosters increased efficiencies and economy within the industry.

RATE TRENDS
USWC - JAPAN



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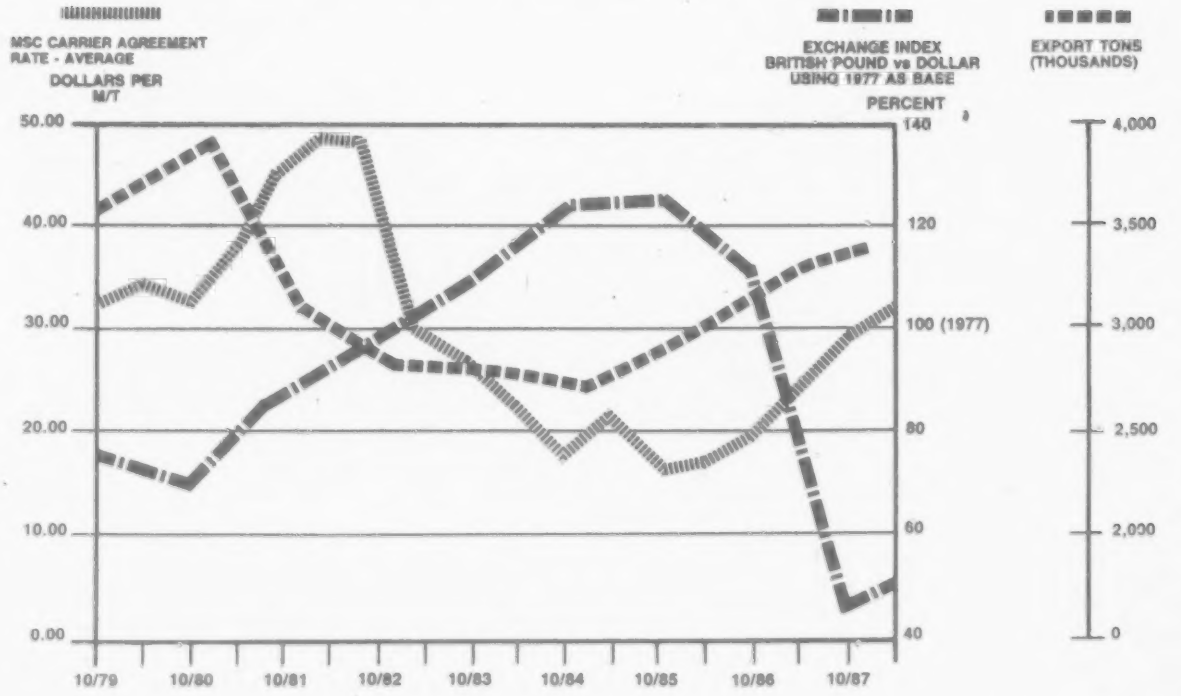
RATE TRENDS
USEC - CONT. EUR/UK



OCT 79 - APR 88

STATEMENT
OF
PHILIP M. GRILL
VICE PRESIDENT, GOVERNMENT RELATIONS
OF
MATSON NAVIGATION COMPANY, INC.
TO THE
SUBCOMMITTEE ON MERCHANT MARINE
MERCHANT MARINE AND FISHERIES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON
MILITARY SEALIFT COMMAND PROCUREMENT POLICIES
August 9, 1988

I am Philip M. Grill, Vice President, Government Relations of Matson Navigation Company, Inc. (Matson). I very much appreciate the opportunity to testify before the House Subcommittee on Merchant Marine concerning Military Sealift Command (MSC) procurement practices and the effect these policies have on the U.S. Merchant Marine. The purpose of my statement is to insure the Subcommittee's awareness of a system of MSC transportation procurement in the U.S. Pacific Coast/Hawaii trade which is working, which permits a constructive working relationship to exist between the MSC and Jones Act carriers, and which insures that both MSC and carriers are treated equitably. More specifically, in the U.S. Pacific Coast/Hawaii trade, Matson and its barge competitors file a significant majority of their rates at the Federal Maritime Commission (FMC) where they are subject to rate of return regulation which insures that freight rate revenue will not exceed carrier costs, plus reasonable profit. It is these tariff rates which the MSC uses, or which form the basis of special rate action by Matson and other carriers to accomodate MSC's particular service needs.

Matson operates a fleet of efficient container and container/trailer vessels carrying primarily containerized cargo and automobiles between the U.S. Pacific Coast Ports of Los Angeles, Oakland, Portland, and Seattle and the Port of Honolulu in regularly scheduled service. Cargo destined for the Neighbor Islands of Hawaii, Kauai, and Maui is transshipped in Honolulu from the line-haul vessels to two Matson container barges and a Young Brothers barge and is delivered weekly to four Neighbor Island ports.

Matson moves cargo under local port-to-port tariffs on file with the Federal Maritime Commission. The carriage of cargo for the Military Sealift Command under tariffs filed at the Federal Maritime Commission is an extremely important part of Matson's Hawaii service. The U.S. government is Matson's largest customer on a revenue basis and we value its business highly. Matson also carries cargo for commercial customers under joint motor-water tariffs on file with the Interstate Commerce Commission, and under through tariff circulars with connecting surface carriers between many inland areas of the United States and Hawaii which are exempt from filing requirements.

Prior to 1974, Section 6 of the Intercoastal Shipping Act, 1933 explicitly permitted the carriage of government and charitable cargo in the domestic offshore trade at free or reduced rates, relative to commercial cargo. This Act was originally enacted in order to subject water carriers operating between the Atlantic and Gulf Coasts and Pacific Coasts via the Panama Canal to economic regulation. The legislative history of the Act reveals that Section 6 (originally Section 4) was proposed for the sole purpose of placing intercoastal steamship carriers on a parity with rail carriers, with which they were presumably competing. Section 22 of the Interstate Commerce Act permitted railroads to charge reduced rates to the government in consideration of their land grants from the government.

In 1938 the provisions of the Intercoastal Shipping Act, including Section 6, were extended to domestic offshore carriers providing service between the Continental United States and Alaska, Guam, Hawaii, Puerto Rico, the U.S. Virgin Islands and American Samoa. Domestic offshore carriers in these trades, therefore, were left subject to a statutory provision which had no historic or economic application to them.

The principal beneficiary of Section 6 had been, of course, the Armed Forces. Section 6 prevented the Federal Maritime Commission from exercising the same economic regulatory authority over MSC rates as it exercised over commercial rates. The effect of Section 6 had been that substantial amounts of MSC cargo were carried at rates significantly lower than those applying to commercial cargoes, resulting in subsidization of the government cargoes by the higher rated commercial cargoes. In addition, as a result of charging lower rates in order to obtain government cargoes, the economic viability of domestic offshore carriers and, ultimately, the level of service were affected adversely.

In 1974 the House Merchant Marine and Fisheries Committee and Senate Commerce Committee recommended legislation which Congress approved that addressed this problem (P.L. 93-487). The legislation was rupported by, among others, the Federal Maritime Commission, the American Institute of Merchant Shipping, the National Industrial Traffic League and the Government of Guam. Only MSC opposed the legislation. Section 6 of the Intercoastal Shipping Act, 1933 was repealed and language was added to Section 5 which made it clear that rates charged for the carriage of government and charitable cargoes in the domestic offshore commerce are subject to the same economic regulation by the Federal Maritime Commission as the Commission exercises over commercial rates in these trades. This has been the case since 1974.

Most cargoes carried by Matson are carried pursuant to tariffs on file with the FMC. Under the provisions of Section 18 of the Shipping Act, 1916 and Section 3 of the Intercoastal Shipping Act, 1933, the FMC regulates the reasonableness of Matson's rate of return on rate base. Although other modes of transportation have been deregulated in recent years, the FMC has been active in using this statutory authority. Most recently the FMC suspended a proposed January 1986 Matson 2-1/2 percent rate increase, conducted an investigation, concluded that the increase would result in an unreasonable rate of return, and disallowed it. In addition, the FMC ordered a further one and one-half percent across-the-board rate rollback which became effective July 6, 1986. As a result, since January 1, 1983, Matson's rates have been subject to only a one percent increase.

Federal Maritime Commission regulations establish extensive requirements for filing financial and operating data which the Commission utilizes in evaluating the reasonableness of rates of return in the domestic offshore trades. This data is filed with all "general rate increases" which result in an increase of more than 3 percent in gross revenue, it is filed in annual financial reports, and Matson has voluntarily filed it in some across-the-board rate increases of less than 3 percent. These reports include detailed data on the carrier's investment in vessels, investment in other property and equipment, administrative and general expense, interest expense and debt payments, inactive vessel expense, depreciation and amortization, construction-differential subsidy refunds (where applicable), other revenue expense, federal and state income taxes, and income account transactions with related companies. Upon reviewing this information, the FMC staff and Commissioners are in a uniquely informed position to decide whether a carrier's overall rate level will result in that carrier earning more than a reasonable profit.

Since the Military Sealift Command, for the most part, uses these tariffs, this FMC regulation insures that MSC freight rates are not excessive and will only yield the carrier a "fair" rate of return on investment.

There is no doubt that if MSC implemented a competitive bidding system in the Pacific Coast/Hawaii trade, there would be a significant reduction in freight rates for military cargoes. While in many respects, MSC is a shipper like any other customer, MSC is much larger than any single commercial customer because it is part of the taxpayer-supported federal government. MSC should not use its publicly supported and, therefore, extraordinarily large economic power to introduce a competitive bidding system that would award huge blocks of military cargo to the lowest bidder.

Whether a liner vessel sails full or 3/4 empty, it costs about the same to make the scheduled voyage. Fuel, maintenance of the vessel, depreciation, crew wages and subsistence, fresh water, and insurance are affected only slightly by the amount of cargo carried. If competing carriers are faced with the prospect of losing significant volumes of military cargo, military rates will clearly decline with the result that commercial shippers will again subsidize those low-rated military cargoes. In numerous trades carriers have submitted low bids, supportable only on an incremental cost basis, so that these large volumes of cargo would not be lost.

In its December 1987 report, the President's Commission on Merchant Marine and Defense addressed the adverse effects that MSC's current contracting practices have upon commercial ship operators. The Commission found that, in some cases, the MSC's policies have driven ship operators to submit bids so low that they may have actually contributed to the financial failures of some U.S.-flag companies. The Commission, accordingly, concluded that MSC should change its policies to a system that would provide rate stability and provide reasonable rates of return on investment. The Commission recommended that MSC change its method of soliciting procurement of ocean transportation services to a stable rate system based on established tariff rates used for commercial shippers. This is the system currently used in the U.S. Pacific Coast/Hawaii trade, and Matson believes it is equitable to all.

The Military Sealift Command is a major and extremely important customer to Matson. We have taken numerous rate actions for the convenience of MSC which offered no advantage to Matson. Matson is committed to providing the best service possible for MSC at reasonable rates. However, competitive bidding, if implemented, would be detrimental to carriers and commercial rate payers alike.

Thank you for the opportunity to present the views of Matson Navigation Company, Inc..

Statement of Jackson A. Baker,
President and Chief Operating Officer
of Sea-Land Service, Inc., Before the
House of Representatives' Committee
on Merchant Marine and Fisheries,
Subcommittee on Merchant Marine

August 9, 1988

My name is Jackson A. Baker. I am President and Chief Operating Officer of Sea-Land Service, Inc., which is the operator of 36 active U.S.-flag container ships. I appreciate the opportunity to submit to this subcommittee Sea-Land's views on the state of the United States merchant marine and on the need for the reform of the Military Sealift Command's procurement policies.

As we are all aware, the United States merchant marine has been in a state of decline since World War II. It transports only a minor fraction of the nation's international trade and its ability to properly support our armed forces abroad in even a relatively minor, one-theater conflict is dubious. Ironically, as the Commission on Merchant Marine and Defense has recognized, the process by which the Military Sealift Command (MSC) procures ocean container shipping services for the armed services has significantly contributed to this decline.

This statement will focus on the decline of the United States merchant marine, and on the role that the Military Sealift Command's procurement policies have played, and continue to play, in that decline. Most importantly, however, Sea-Land would like to propose a series of modest, interrelated reforms to the MSC's procurement policies that will prevent the Government's own procurement policies from further contributing to this decline. Indeed, we believe that the reforms would make MSC a positive force in revitalizing the nation's merchant marine.

I am sure that I do not need to describe in detail the state of the U.S.-flag merchant fleet. Following World War II, the U.S.-flag merchant marine was the world's largest in terms of both the number of ships and in dead-weight tonnage. Now, however, the U.S. merchant marine has fallen to eleventh in the number of ships and eighth in dead-weight tonnage. In June 1947, for example, there were 2,114 active ships of over 1,000 gross registered tons under U.S. flag. In January 1987, however, the number of active U.S. merchant vessels had fallen to 369. Over that same period, the number of inactive ships dropped from 1,583 to 351.

The decline has been especially precipitous in recent years. In our own segment of the industry, for example, there were 25 American carriers operating liners in international trade in 1968. By 1970, that number had fallen to 20 liner companies, and, by early 1988, had declined still further to 6 liner companies. This decline is expected to continue. In its first report, the Commission on Merchant Marine and Defense estimated that the privately owned U.S.-flag general cargo fleet would shrink an additional 55 percent in size by the year 2000.

This dramatic erosion of the American merchant fleet has forced the United States to rely increasingly on foreign merchant fleets for its international trade. More than 90 percent of American foreign trade travels by sea. However, American merchant vessels carry just 4 percent of this ocean-borne commerce; by contrast, U.S.-flag merchant vessels carried nearly 60 percent of America's ocean-borne international trade in 1948. By the year 2000, this

Commission has estimated that U.S.-flag vessels will carry only 1 percent of this nation's international trade.

The alarming degree of American reliance on foreign vessels is graphically illustrated when compared to the figures for other nations. The Soviet fleet, for example, carries more than 50 percent of its ocean-borne international trade, the Greek fleet carries 48 percent of its trade, and the Japanese fleet 39 percent of its trade. Although these figures have ominous implications for the international competitiveness of the U.S. merchant marine, perhaps the gravest implication of the decline of the American merchant fleet may be its impact on our ability to support our armed forces overseas.

Although sealift will be required to deliver approximately 95 percent of all dry cargo and 99 percent of the petroleum products in a major overseas deployment, the Commission on Merchant Marine and Defense concluded in its first report that "[c]urrent sealift capability, both in size and ship type, is inadequate for defense purposes even if all available assets were to be used."

Moreover, the Commission projects that, by the year 2000, "the United States will not have the capability to meet its sealift objectives, even in a single-theater, limited conflict." For example, the Commission has estimated that by the year 2000 the active U.S.-flag merchant fleet would number only 220 vessels while a global war would require a minimum of 440 cargo ships and 350 tankers. To support the domestic economy during such a war would demand another 344 cargo ships and 244 tankers.

The ability to properly sustain our troops abroad is even more crucial now, given the reduced reliance on nuclear weapons in Europe, the INF Treaty, and the increased likelihood of conventional conflicts in the Persian Gulf and elsewhere in southwest Asia. As Admiral Denton, the Chairman of the Commission, has concluded, the state of U.S. maritime affairs poses "a clear and present danger to the national security of the United States, [and] the situation will only worsen substantially by the year 2000."

Admittedly, the causes of this decline are both numerous and complex. Nonetheless, the Commission on Merchant Marine and Defense has recognized that the method by which the military sealift command procures military ocean shipping services has significantly contributed to this decline. The principal problem is MSC's insistence on procurement policies that focus exclusively on achieving short-term cost savings, notwithstanding the adverse impact that such policies have on the continued viability of the domestic merchant marine.

Currently, for example, in order to reduce its short-term costs, MSC is willing to charter vessels owned by foreign interests, and to award contracts to carriers having no prior shipping experience. While the desire to obtain lower shipping costs in the short-term is superficially appealing, these short-term policies further contribute to the decline in our merchant fleet and carry long-term cost implications for this nation that far outweigh any short-term savings that may be achieved. MSC's current procurement policies are a clear case of "penny wise, pound foolish."

The Commission on Merchant Marine and Defense acknowledged that the "short-term government savings are obtained only at long-term costs to the United States-flag operators." The Commission noted that it was "particularly concerned about the adverse affects of current contracting practices upon the operators of commercial ships." Because

of these practices, this Commission determined that "ship operators have been driven to submit bids so low as to be destructive, a practice that may have contributed to the financial failures of some ship operators."

In its second report, the Commission on Merchant Marine and Defense recognized the need to revamp MSC's procurement policies. The Commission proposed replacing the current bidding system with a tariff-based system. Although Sea-Land concurs completely in the need to effect a change in current policies, Sea-Land believes that the basic structure of the current procurement system -- in which carriers compete for cargo on the basis of service and price -- can and should be retained. We believe that the reform that is needed can be accomplished most effectively through a series of modest and interrelated changes to the MSC's current policies.

The reforms proposed by Sea-Land have three basic goals: (1) to ensure that the Government's procurement policies enhance, rather than inhibit, the long-term viability of the U.S.-flag merchant fleet and its international competitiveness; (2) to ensure that such policies enhance, rather than jeopardize, the continuing availability of a national emergency sealift capability; and (3) to accomplish these objectives at the lowest long-term cost to the nation.

Sea-Land has identified six areas in which the procurement policies of the military sealift command should be reformed. This statement will describe each of them briefly. Attached to this Statement is an analysis that more fully explains each reform and why its adoption is necessary.

The first area of concern is a loophole in the Cargo Preference Act of 1904. That Act requires that military cargoes be shipped in U.S.-flag vessels. However, because of this loophole, such shipments may be made on vessels ultimately owned and operated by foreign economic interests that have flagged the vessels in the United Stated through a domestic subsidiary or shell corporation.

Foreign economic interests, particularly the Danish Maersk line, have been exploiting this loophole in order to carry cargoes intended to support domestically owned and controlled merchant ships. If this loophole is not closed, other foreign interests are likely to follow Maersk's lead. Such practices would completely vitiate the mandate of the Cargo Preference Act of 1904. Every dollar lost to American shipping interests is a dollar received by its foreign competition.

In order to ensure that the domestic merchant fleet receives the benefit of the 1904 Cargo Preference Act, Sea-Land proposes that vessels carrying military cargo overseas must be ultimately owned 75 percent or more by U.S. citizens. There is ample precedent for this approach. For example, current law imposes similar requirements on ships that receive differential subsidies and on ships that engage in the coastwise trade.

We believe that this enhanced citizenship requirement will have two important benefits. First, the enhanced citizenship requirement will ensure that cargo shipped by the Military Sealift Command will support only the bona fide domestic merchant marine. The cargo preference laws of the United States, including the Cargo Preference Act of 1904, are intended, in part, to ensure the availability of sealift during national emergencies by providing the domestic merchant marine of U.S. with guaranteed cargoes during peacetime. Limiting the guaranteed cargoes to bona fide domestic vessels will ensure that the U.S. merchant fleet

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receives the full benefit of the guaranteed cargoes and that foreign economic interests do not siphon off the cargoes that provide the investment incentive and investment resources so badly needed by the domestic merchant marine.

Second, it will enhance the likelihood that sealift will be readily available to the government in the event of national emergencies. Although U.S.-flag ships that are owned by foreign economic interests are theoretically available for requisition by the U.S. during a national emergency, the government cannot be as confident about the availability of such ships as it is in the case of U.S. citizens. Our experience during the 1973 Yom Kippur War, illustrates these concerns. During that conflict, there were concerns both that Liberia would ban the use of U.S.-owned, Liberian-flag vessels in sealift to Israel and that certain European nations would deny overflight rights and the use of air fields in Europe.

The second reform that we propose would require that carriers have at least one year of operational liner experience to be eligible to receive cargo contracts. Under the federal procurement regulations, any carrier satisfying this or any other qualification requirements would be listed in a "Qualified Bidders List" available to the public.

Currently, MSC will award cargoes to a carrier even if that carrier has no prior operational experience. The effect of this practice is two-fold. First, it permits carriers that are unlikely to be capable of safe, efficient, and dependable service to receive awards. Second, it allows speculators who are not committed to the shipping business to enter the bidding process. Because these speculators have not made the capital commitments necessary to be competitive and because they have no intention of staying in the shipping business long-term, they are able to submit artificially low bids for cargo routes. bona fide carriers are forced either to meet these bids at rates that do not provide adequate returns or to give up the business.

Providing preference cargoes to such speculators is a classic example of sacrificing long-term stability in the merchant marine for a short-term cost saving. Providing cargo to speculators at the expense of carriers committed to the shipping industry long-term furthers the decline of the domestic merchant marine; if this process continues, the nation will ultimately bear the extraordinary long-term cost of providing its own sealift capacity.

There is precedent for the requirement of prior experience that Sea-Land proposes. The Military Airlift Command imposes a similar one-year operational experience requirement on its commercial air carriers.

This reform will provide two important benefits. First, it will enhance the likelihood that awardees are capable of providing safe, efficient, and dependable service. Second, it will lessen the likelihood that speculators, who have no intention of remaining in the shipping business over the long term, will siphon earnings away from the bona fide domestic merchant fleet. Therefore, the one-year operational experience requirement would both improve service and target the limited resources available to enhance the nation's merchant marine and its emergency sealift capability on those carriers that are most likely to fulfill those goals.

The third reform proposed by Sea-Land would penalize carriers that fail to initiate service after winning a contract award. Those penalties could involve strict enforcement of contractual provisions relating to the offeror's failure to initiate service, or the imposition of bid guarantees and performance bonds. Currently, low bidders

may refuse to initiate service with impunity. This allows speculators not committed to performing the contract to submit artificially low bids to get the contract and then decide whether they can or want to perform. This drives bid prices down to levels below those that will provide a strong merchant marine.

The imposition of penalties for failure to initiate service will produce three important benefits. First, penalties will enhance the integrity and efficiency of the bidding process because they will discourage offerors that are unable or unwilling to initiate service from artificially driving down bid prices, as happened recently when Apex Marine -- which won the right to carry 75 percent of the MSC's cargo between the East Coast and Europe with an extremely low bid -- declined to begin service.

Second, the penalties for failure to initiate service will also reduce the government's long-term costs. Although short-term costs are reduced when speculative bidders drive down the bids of responsible carriers, the MSC's long-term costs will be increased if the responsible carriers are driven from the market because the low bid prices are insufficient to sustain their operations.

Third, the penalties will also improve the predictable availability of sealift to the MSC because carriers will be more likely to initiate service if they are subject to penalties for failing to do so and, therefore, the government will be more likely to receive the benefit of the low offer to which it is entitled.

The fourth reform that we propose would require that the MSC distribute cargo on a given route among a larger number of carriers. Currently, on certain routes MSC awards 75 percent of the available cargo to the low bidder and the remaining 25 percent is divided among other carriers on the route. This practice is designed to ensure that more than one carrier will be supported by the military cargoes. However, the remaining 25 percent may be insufficient to sustain a second carrier and is almost certainly insufficient to sustain more than one additional carrier. Moreover, the potential and unpredictable fluctuation between the maximum 75 percent award and an award of 25 percent or less discourages capital investment in sealift assets by the carriers. Such investment is essential if U.S. carriers are to remain competitive in international trade.

We propose that a cargo distribution index be devised to reduce the maximum cargo available to the highest bidder to perhaps 60 percent on routes with two carriers, to 50 percent on routes with three carriers, and to 45 percent on routes with four or more carriers. The remaining cargo would be split among the other carriers available on a route.

This cargo distribution index would have two important advantages. First, it would broaden the nation's emergency sealift capability base by providing at least minimally adequate levels of cargo to a larger number of carriers than the current scheme, and will therefore ensure that additional carriers have sufficient cargoes to sustain their operations.

Second, the cargo distribution index will minimize the dramatic swings in revenue from cycle to cycle and provide the greater degree of predictability that is required for sound financial planning and capital investment. This, in turn, will enable domestic carriers to develop the assets needed to remain competitive in today's markets.

The fifth reform we propose would more fairly support carriers making large voluntary commitments to the

Sealift Readiness Program. Under that Program, committed ships are subject to call-up by the Government during national emergencies.

Cargo is now offered to carriers based on their bid prices. Under the proposed reform, cargo would still be offered to carriers based on their bid prices, but carriers making commitments in excess of those required would be paid the prices bid, plus an additional amount, for each ton of cargo hauled. The size of the additional amount would increase as the number of ships voluntarily committed increased. This reform is intended to serve the same goals as the Military Airlift Command's procurement policy, which distributes cargo to air carriers based, in part, on the number of aircraft committed to the Civil Reserve Air Fleet, the air transport counterpart to the Sealift Readiness Program.

This recognition of a carrier's commitment to the Sealift Readiness Program will have two important benefits. First, it will increase the level of sealift available to the government during a national emergency, because it will provide incentives for additional voluntary commitments to the Program. Second, the recognition of a carrier's level of commitment to the Sealift Readiness Program will support more fairly those carriers with large capital investments in Program-committed ships and related infrastructure.

The sixth, and final, reform proposed by Sea-Land would require that the MSC strengthen and consistently implement its current policy to ship by common carrier, including liners, when such vessels are available, rather than by vessels chartered by the MSC. This policy is embodied in the Wilson-Weeks Agreement, which was executed by the Departments of Defense and Commerce in 1951, and was amended in 1954.

The strengthening and consistent implementation of this policy will serve two important goals. First, it will ensure that the common carrier segment of the industry, which is particularly important for the viability of the domestic merchant marine, receives the "base" military cargoes upon which that segment of the industry is so reliant. If the common carriers have insufficient cargo to sustain operations, they will be unable to support the domestic economy or to provide a national emergency sealift capability.

Second, the preference for common carriers should reduce the MSC's short-term costs -- because it is generally more expensive for the MSC to ship cargo by its chartered vessels than by common carrier -- and its long-term costs -- because the national emergency sealift capability provided by a healthy common carrier segment will not need to be replaced by Government ships.

Each of these reforms is necessary to eliminate the detrimental impact that the MSC's procurement policies have had and are having on our industry, on the international competitiveness of our economy, and on our national security. Sea-Land urges you to study them carefully and to work for their adoption.

(Submitted by Sea-Land Service, Inc., August 9, 1988)

MILITARY SEALIFT COMMAND
PROCUREMENT REFORM

Executive Summary

Need for Reform:

- The U.S. merchant marine is in a state of decline. In 1950, it was first in the world in number of ships and deadweight tonnage. Today, it is eleventh and eighth, respectively.

- This decline has grave economic and national security consequences. Today, the U.S. merchant marine carries just 4 percent of our ocean-borne trade. Similarly, the merchant fleet is inadequate to support our armed forces overseas in a national emergency. Both of these trends continue to worsen.

- The Commission on Merchant Marine and Defense (the Commission) has recognized that the Military Sealift Command's (MSC's) ocean shipping service procurement policies have contributed to this decline. Those policies focus solely on achieving short-term cost savings, without regard to the adverse impact they have on the long-term viability of the domestic merchant marine and on the nation's emergency sealift capability.

- The Commission has recognized the need to effect a change in MSC's procurement policies and has suggested abandoning the current method of procurement in favor of a tariff-based system.

- Sea-Land concurs in the need for procurement reform but believes that the needed reforms can be achieved through relatively modest modifications to MSC's current competitive procurement policies.

Goals of the Reform:

- Sea-Land's reform proposals have three goals: (1) to ensure that the MSC's procurement policies do not further damage the domestic merchant marine; (2) to ensure that those policies enhance the availability of a national emergency sealift capability; and (3) to do so at the lowest long-term cost to the nation.

The Six Interrelated Reforms:

- Limit cargo awards to U.S.-flagged vessels ultimately owned 75% or more by U.S. citizens. Currently, foreign-owned vessels are eligible to receive MSC awards. These awards siphon off preferential cargoes that should support bona fide domestic carriers. In addition, such a requirement will enhance the practical availability of sealift capacity in time of a national emergency.

- Require one year of regular operational experience before a carrier is eligible for an award and promulgate a "Qualified Bidders List." Currently, awards can be made to carriers with no operational experience. Frequently, such carriers are speculative ventures that have not made the investments in capital assets required of a competitive carrier in today's market. As a

consequence, these bidders can bid artificially low prices that are not economically feasible for carriers required to make long-term commitments in capital assets. In order to compete with these bidders, established companies are forced to submit bids so low as to be destructive. In addition, inexperienced carriers may not be capable of safe, efficient, and dependable service. Moreover, awards to speculators provide profits to the speculator but do not enhance a long-term emergency sealift capability.

- Penalties for carriers that fail to initiate service after contract award. Currently, low bidders may decline to initiate service after an award is made and incur no penalty. As a consequence, speculators enter the bidding process and artificially bid down prices to obtain the contract. When these companies fail to initiate service, other responsible carriers must perform at artificially low rates that may be insufficient to sustain the capital investment necessary for a viable carrier. Imposing a penalty for failure to initiate service will discourage non-responsible bidders from entering the process and will enhance the likelihood that low bidders will perform.

- Broader distribution of cargo on routes with more than one carrier. Currently, the lowest bidder on certain routes is entitled to up to 75% of the cargo. The remaining 25% may not, however, be sufficient to sustain additional carriers. Moreover, the unpredictability inherent in the potential 75%/25% swing from cycle to cycle inhibits sound financial planning by ship operators and discourages additional capital investment by them.

- Recognition of a carrier's level of voluntary commitment to the Sealift Readiness Program (SRP). Currently, the prices paid for shipping cargo are not related to a carrier's level of voluntary commitment to the SRP. Therefore, there is no incentive for additional commitments to the SRP, and carriers making commitments are not fairly supported. A recognition of the carriers' voluntary level of commitment, by paying carriers an additional amount, determined as a percentage of their bid price, will provide such incentives and support carriers commensurate with the level of commitment. The percentage would increase as the number of ships voluntarily committed increased.

- Strengthen policy to ship by common carrier, when available, rather than by MSC-chartered vessel. A failure to consistently implement MSC's policy in favor of shipments by common carrier needlessly endangers that segment of the industry and increases short-term and long-term costs. Strengthening the policy will help ensure the economic viability of the liner trade and will reduce the costs to the Government.

PREPARED STATEMENT OF TIMOTHY J. RHEIN, PRESIDENT, AMERICAN PRESIDENT LINES, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE ON AUGUST 9, 1988

Mr. Chairman, members of the Committee, I am Timothy J. Rhein, President of American President Lines (APL), a wholly owned subsidiary of American President Companies (APC).

APL moves containerized cargo across the Pacific and Indian Oceans with its fleet of 23 U.S.-flag vessels. We operate three scheduled "line haul" services per week between Asian "hub" ports (e.g., Japan, Taiwan, Hong Kong) and three U.S. West Coast ports (Seattle, Oakland, Los Angeles). We move cargo between Asian "hubs" and smaller Pacific and Indian Oceans ports using "feeder" vessels.

Together with APC's other subsidiaries providing rail and truck transportation, container handling, and information services, APC is a world leader in providing intercontinental point-to-point intermodal transportation to its customers.

APL appreciates this opportunity to submit to the Subcommittee its views concerning the policy and procedures of the Military Sealift Command (MSC) for the procurement of ocean transportation.

Background

The members of this Committee know all too well the facts and implications of the tremendous decline in the American merchant marine. The number of American carriers and ships available to the military in both peace and war has decreased sharply.

For example, liner vessels -- which have traditionally provided the majority of the vessels available for immediate military use -- have declined from 434 in 1970 to 112 in 1988. This number is projected to decline further during the next five years.

The Commission on Merchant Marine and Defense, in its first report, found "clear and growing danger to the national security in the deteriorating condition of America's maritime industries." Indeed, the Commission warned that if present trends continued, "the United States will not have the capability to meet its sealift objectives, even in a single-theater, limited conflict."

The Commissioners examined and expressed concern about the adverse effects of MSC's current contracting practices upon the long-term viability of U.S.-flag commercial operators. They noted that MSC was preoccupied with a short-run view of moving cargo at the lowest possible cost each time -- even if such bids were so low as to be destructive to the merchant marine in the long run. To put it in economic terms, MSC requires bids which barely cover variable costs but do not cover long-run average (or "fully distributed") costs. The result of MSC's bidding practices may have contributed to the financial failures of some U.S.-flag ship operators and the declining number of U.S.-flag vessels.

The Commission's Recommendations

In its second report, the Commission called for changes to Department of Defense and Department of the Navy policies, regulations and practices in order to:

- Support the U.S.-flag vessels which will have to provide the sealift capability to meet mobilization requirements

- Provide ship operators with rates that more accurately reflect fully distributed costs and provide reasonable rates of return on investment

- Stabilize shipping rates for a longer period of time

- Encourage United States-flag carriers' efforts to

upgrade to new ships and equipment that increases productivity and meets military as well as commercial requirements

- Provide the Department of Defense with comparable and equitable shipping rates from more than one carrier on the same route; and

- Prevent the unsatisfactory service that may result when unproven or speculative carriers "buy in."

The Commission also recommended that the Department of Defense, in conjunction with the Federal Maritime Commission and the Maritime Administration, change the method of solicitation for procurement of ocean transportation services. They recommended initiating a stable rate system based on the established tariff rates used by commercial shippers. They further recommended that those rates could be reduced by an established and agreed percentage based on the large volume of DOD cargo.

APL's Position

APL supports the goals articulated by the Commission on Merchant Marine and Defense. APL agrees with the Commission that the current MSC procurement system has produced rates which have not covered fully distributed costs. Moreover, MSC's current practice of awarding 75 percent of available cargo to the low bidder and the remaining 25 percent among other carriers on any given route causes great instability in cargo volumes between each six month contract period. This instability has made planning for procurement of equipment to support the needs of both commercial and government customers very difficult.

We believe that the problems with MSC's current procurement system can be remedied, and the goals of the Commission achieved, by following a two-step approach.

First, as an immediate step, we believe the following actions should be taken:

1. Strengthen citizenship requirements for companies eligible to carry military cargo under the 1904 Act. Vessels eligible to carry military cargo should be ultimately owned 75 percent or more by U.S. citizens. This rule is in effect currently for ships engaged in coastwise trade and for those on which operating differential subsidy is paid.

2. Require an American carrier to have at least one year of commercial liner experience in order to be eligible to bid for the carriage of military cargo. This will ensure the government of efficient and dependable service, while at the same time assisting those carriers who are committed to and capable of serving the broader commercial market. Such a requirement also would bring ocean procurement procedures in line with those required of airlines for carrying military cargo.

3. Adjust MSC's current cargo distribution policies to provide support to a larger number of carriers. MSC's current policy of awarding 75 percent of the available cargo to the low bidder and the remaining 25 percent among other carriers on the route is designed to ensure that more than one carrier will be supported by military cargoes. However, 25 percent of the available cargo may be insufficient to help sustain even one other carrier. Therefore, APL recommends that the particular cargo distribution among the winning bidder and other carriers be determined by the government based on the number of participating carriers in the particular trade route.

4. Assess penalties against a winning bidder if he fails to provide basic service in accordance with the contract. There is a history of carriers submitting unrealistically low bids, winning contracts, and then never peforming -- without penalty. This makes it difficult for the government to meet its transportation requirements while at the same time harming carriers who have submitted competitive bids. The assessment of penalties would eliminate speculative bidders and improve the predictability of sealift available to MSC.

5. Implement strictly MSC's current policy of shipping by commercial common carriers rather than by vessels chartered to MSC. Clearly, the essential idea behind the cargo preference requirements is to support a commercial fleet which will be called upon to provide essential defense sealift requirements during times of war or national emergency. Moreover, such a policy should also reduce MSC's costs because it is generally more expensive for MSC to ship cargo by its chartered vessels.

The foregoing recommendations can and should be implemented immediately. Yet together they still will not eliminate MSC's tendencies to require destructively low bids on some trade routes. Further reforms of the ocean transportation procurement system may need to be implemented to ensure that an efficient carrier can earn a fair return on his investment while providing the government with effective service at reasonable freight rates.

Therefore, if additional reform is necessary, we believe a military tariff should be established in place of the current bidding system. These military tariffs would reflect the special

nature of military cargo, although they would need only include the current commodity categories (cargo NOS, POVs, reefers, and breakbulk). The military tariffs would incorporate the same general rules as commercial tariffs, including equipment substitution, surcharges, etc.

Importantly, intermodal rates also would be included. A great deal of the military cargo which moves port-to-port under the existing system would move on an intermodal basis at a substantial savings to the government while achieving improvements in service.

In addition, the use of service contracts under the tariff would provide the military with an opportunity to obtain lower rates in exchange for volume commitments. Under the current system, the military does not provide any volume forecast or volume commitment. This reduces the planning capability of the carrier and increases costs.

Commercial shippers have significantly benefited from increases in the efficiency of ocean transportation. These same gains can be applied to the carriage of military cargo in peacetime and upon mobilization.

Conclusion

MSC's current procurement system basically focuses on the lowest cost for each movement of cargo -- without regard to the impact of such a system on the long-run vitality of the merchant marine necessary for defense mobilization requirements. This makes no sense: supporting a privately owned merchant fleet manned with merchant seamen is the most cost-effective means of fulfilling essential national defense sealift requirements. A government-operated fleet would be inordinately expensive given naval ship acquisition costs and naval manning. Yet a mothballed reserve fleet of sufficient size presents readiness and maintenance problems and does not ensure crews to man the ships in war.

Therefore, it is important that the current MSC procurement system be reformed to support the long-term vitality of an adequate American merchant marine that will meet the government's needs. APL has a long history of supporting our Navy, both in peace and war. Today, all of our ships are committed to the Sealift Readiness Program. We believe it is important to see an MSC procurement system implemented that will effectively meet the needs of both the government and U.S.-flag carriers.

MAERSK LINE, LIMITED

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August 23, 1988

The Honorable Walter B. Jones
Chairman
Committee on Merchant Marine and Fisheries
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

We would like to submit the following letter for the record pursuant to the deliberations of the Merchant Marine Subcommittee and its effort to review the procurement practices of the Military Sealift Command. Sea-Land Service, Inc. provided comments for the record which we do not agree with and believe must be clarified.

Sea-Land suggested six reforms that should be followed to achieve three goals: (1) ensure that the government's procurement policies enhance, rather than inhibit, the long-term viability of the U.S.-flag merchant fleet and its international competitiveness, (2) ensure that such policies enhance, rather than jeopardize, the continuing availability of a national emergency sealift capability, and (3) to accomplish these objectives at the lowest, long-term cost to the nation. These goals are, of course, admirable and fully supported by Maersk Line, Limited. Unfortunately, we cannot agree with Sea-Land's first recommendation that the citizenship requirements be amended because our nation's sealift resources are imperilled by the use of reflagged tonnage that somehow would not be accessible during a national emergency. Maersk Line, Limited was used as an example by Sea-Land as a company controlled by a "foreign economic interest" intentionally exploiting the Cargo Preference Act of 1904. We obviously do not share this view since: (1) our company is not "controlled" by a "foreign economic interest," (2) we do not view the Cargo Preference Act of 1904 as a law that can be intentionally exploited for individual gain, and (3) we do not believe that raising the citizenship requirements will somehow enhance national security.

Maersk Line, Limited is a Delaware corporation which has been chartered since 1947. As a domestic company, we share a tax liability comparable to any other similar corporation involved in the shipping industry. We are also

proud to employ sailors from the Seafarers International Union and officers from the Marine Engineers Beneficial Association, District 2. It should be recognized, Mr. Chairman, that Maersk Line, Limited has successfully met government prerequisites in order to be awarded U.S. Navy contracts. However, Sea-Land asserts a link between citizenship and "control" of tonnage during a national crisis. In our view, this is a moot point since we are a domestic company that operates U.S.-flag ships. Any U.S.-flag ship or any U.S.-flag ship chartered to the U.S. Navy will be used in any manner to meet the military needs of our country during a national emergency. Furthermore, our officers typically hold a Commission in the U.S. Naval Reserve.

American Automar and Central Gulf Lines are two excellent examples of U.S. corporations that have chartered reflagged tonnage to the Military Sealift Command. We would be remiss if we did not bring to your attention the fact that the "American Eagle"--a reflagged Roll On, Roll Off vessel--was successfully used for logistic support purposes during the Grenada conflict.

We could provide you and the Subcommittee with additional rationale that refutes Sea-Land's submission, but it would be counterproductive. In our opinion, the more important issue is how we can develop and maintain an efficient, cost effective U.S. merchant marine--not whether a company's market share can be expanded by inhibiting competition. Maersk Line, Limited consistently strives to provide a first class service. We believe that one ingredient for our success is to be cooperative and service oriented. We value our reputation and our working relationship with the Government. Be assured that Maersk Line, Limited stands ready to work with Congress, the U.S. Navy, and industry representatives in any manner that will create employment and assure a viable U.S.-flag merchant fleet.

Respectfully yours,

John E. Bouchard

John E. Bouchard

bcc: Cynthia Wilkinson
Kip Robinson

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August 2, 1988

BY HAND DELIVERY

The Honorable Walter B. Jones
Chairman, Committee on Merchant
Marine and Fisheries
1334 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The United Shipowners of America appreciate being invited to testify at the Military Sealift Command Oversight Hearing being held by your Merchant Marine Subcommittee on August 9, 1988.

Reform of MSC procurement practices is essential if the United States is to have a healthy and growing liner fleet. Accordingly, several months ago we undertook a comprehensive study of how procurement could be modified so as to insure quality service to the DOD at rates that were fair and reasonable to the shipper and the carrier. This study is still under way and will not be completed until late summer or early fall. Thus, we are not in a position to present a detailed proposal for your consideration at this time. In addition, since we have not seen the study of MSC procurement practices conducted by the General Accounting Office, we cannot comment upon that at this time. We would be happy later this year to both present a detailed proposal and comment on the GAO study if you decide to hold further hearings.

On July 20, 1988, I testified before the Commission on Merchant Marine and Defense and included a statement of our preliminary conclusions with regard to desirable reform in MSC procurement. Since it is pertinent to the purpose of this hearing, it is quoted below:

> "We agree with the finding of the Commission that '. . . some regulations, policies and practices of the Department of Defense and the Department of the Navy have an adverse effect on the United States maritime industries' and that 'To obtain Department of Defense cargo, upon which the industry is so dependent, in some cases ship operators have been driven to submit bids so low as to be destructive, a practice that may have contributed to the financial failures of some ship operators.'

We believe that the time for an objective review and revision of MSC liner procurement practices is long overdue. For too long there has been an atmosphere of friction rather than cooperation, with MSC seeking to move its cargo at the lowest possible cost and the carriers wanting a fair rate of return. While both motives are understandable, they are not necessarily compatible. A solution must be arrived at whereby the carriers can provide a cost-efficient service to MSC and at the same time earn a return on investment that will enable them to replace their fleets.

We have studied with interest the Commission's recommendation that '. . . rates charged for the carriage of Department of Defense cargo should be based on rates filed by the carriers with the Federal Maritime Commission and could be reduced by an established and agreed percentage based on the large volume of Department of Defense cargo.' Implementation of such a procedure will require thorough analysis since many complex questions must be addressed. We would suggest that while that approach is being studied, a modified version of the existing bid system be put into place as at least an interim solution. The basic objectives of any revised system should include:

* Improved rate stability.

* Improved volume predictability.

* Reduced impact of speculative bidders by requiring commercial liner operating experience on any U.S. international trade route for a definite period of time as a prerequisite for carrier bidding eligibility.

* Strengthen the citizenship requirement for eligible bidders on international contracts by establishing citizenship requirements similar to those in the Jones Act.

* Establish penalties for carrier failure to provide basic service after issuing the bid and require a bid bond to cover the penalty.

* Establish a system of cargo distribution that will ensure a fair share participation by bidders.

* Maintain and improve the military liner market.

* Recognize each carrier's asset commitment to the Sealift Readiness Program.

The members of USA are committed to working with leaders of the U.S. Transportation Command and the Military Sealift Command to agree upon and implement revised procurement procedures which will ensure DOD efficient service at reasonable rates and offer the carriers a fair rate of return so that they can reinvest in the transportation systems required to support foreign military emergencies."

We will follow the hearing on August 9th with a great interest and encourage the Committee to hold further hearings on this subject in the reasonably near future. We would appreciate having this statement included in the hearing record.

Yours sincerely,

Albert E. May

Albert E. May
Executive Vice President

AEM/icl

DEPARTMENT OF THE NAVY
COMMANDER MILITARY SEALIFT COMMAND
WASHINGTON, D.C. 20398-5100

REFER TO

30 September 1988

The Honorable Walter B. Jones
Chairman
House Merchant Marine and Fisheries Committee
1334 Longworth Building
Washington, D.C., 20515

Dear Mr. Chairman:

During my testimony on 9 August 1988, I was asked to comment on the statement by Jackson Baker, President of Sea-Land Services, Inc., in which he proposed six fundamental changes to the Military Sealift Command's methods of procuring ocean transportation services.

I do not support Mr. Baker's proposed amendments to the procurement procedures for ocean transportation. The proposals are unnecessary and would not result in any improvement in the efficiency or economy of the U.S. flag merchant marine. Moreover, the proposed changes are contrary to the established Government policy favoring competition and treating all qualified bidders equally - a policy which underlies MSC's procurement system and is embodied in federal law regulating Government procurement.

Sea-Land's proposed amendments are directed toward creating policies which will significantly restrict new investment and growth by erecting artificial and unreasonable barriers to investors. The result will be a stifling of innovation for the American merchant marine during a period in its history when the Government should be taking an opposite approach by being flexible and encouraging participation by those with private capital, foresight and new ideas. Ensuring that all U.S. flag ships have an equal and unencumbered access to Government impelled cargoes is a formidable aid that the Government must employ to maintain a viable U.S. flag merchant fleet to meet our defense needs.

In contrast to this concept, Sea-Land's proposed amendments would result in disincentives for new investment in the merchant marine further eroding the number of American flag ships and jobs for U.S. citizen crews. Changing the procurement policies as suggested would erect anti-competitive barriers to the sole benefit of a few carriers and to the detriment of all other parties, including the Government in meeting its military sealift requirements. Accordingly, I do not endorse the amendments proposed by Mr. Baker.

In further discussion of this position I have attached hereto a detailed response to each of the six proposed amendments.

I thank you for the opportunity to elaborate on my testimony. Please let me know if I can be of further assistance to you and the Committee.

Sincerely,

W. T. PIOTTI, JR.

MILITARY SEALIFT COMMAND'S COMMENTS TO CHANGES SUGGESTED BY JACKSON BAKER

Mr. Baker's statement recommends six significant changes (labeled "reforms") to the Military Sealift Command's (MSC's) procurement policies and practices, most of which have already been considered by the Commission on Merchant Marine and Defense and the General Accounting Office in its report of August 9, 1988. Citing the report of the Commission on Merchant Marine and Defense, the basic premise underlying Mr. Baker's statement is that MSC's procurement policies have damaged the U.S. Merchant Marine, thereby contributing to its decline. However, there is no evidence to suggest that this assertion is correct. In fact, at a recent Federal Maritime Commission industry conference held in Long Beach, California, February 18-19, 1988, senior officials of U.S. and foreign flag carriers, including Sea-Land Services, Inc., blamed overtonnaging on major trade routes, the imbalance of trade, the use of service contracts, independent action authority in response to market demands and foreign Government policy, as among the major factors contributing to the industry's problems. Conspicuously absent during the Federal Maritime Commission conference on shipping rates and the Shipping Act of 1984 was any mention by U.S. flag carrier officials that Department of Defense (DOD) liner procurement policies and practices were a cause of the industry's decline.

In the August 9, 1988 report, the General Accounting Office (GAO) concluded that MSC's policies and practices regarding procurement of ocean transportation services are consistent with Government procurement policy. The GAO went on to point out that the Government is faced with two competing objectives: the requirement of competitive procurement to obtain services at the lowest possible cost and the need to maintain a mobilization base. If changes to the present procurement system are made, they would no doubt result in significant cost increases to the Government (as high as 80%). GAO specifically stated both in its report and in its Congressional testimony, that such costs should be fully identified and disclosed. Thus, GAO recognized that such changes were tantamount to subsidies that should be consciously and deliberately revealed, debated, and if then found to be in the Government's best interest, authorized. The foregoing is borne out in a recently completed Harbridge House report.

Mr. Baker has recommended the following six changes to MSC's procurement policies:

1. Require vessels carrying military cargo overseas to be

owned 75% or more by U.S. citizens;

2. Require carriers to have one year of operational liner experience to be eligible to receive an award of a contract;

3. Impose penalties upon carriers that fail to initiate service after award of a contract;

4. Lower the maximum percentage of cargo limitation on major trade routes under the MSC worldwide container agreements;

5. Recognize a carrier's excess level of voluntary commitment to the Sealift Readiness Program through payment of the prices bid plus an additional amount for each ton of cargo transported. The size of the additional amount would increase as the number of ships voluntarily committed increases; and

6. Strengthen the policy to ship by common carrier, including liners, rather than by vessels chartered by MSC.

The first requirement for at least 75 percent U.S. ownership of vessels carrying military cargo is unduly restrictive and beyond current statutory and regulatory requirements. The Cargo Preference Act of 1904 requires that Department of Defense cargo be transported in U.S. flag vessels. Requiring that seventy-five percent of the financial interest in the vessel be owned by U.S. citizens exceeds the requirement for the flagging of a vessel under U.S. registry and will discourage growth in the number of vessels under U.S. registry. Nor will this requirement increase employment opportunities for U.S. mariners as present U.S. flag requirements already mandate that all of the ship's officers and 75 percent of the crew be U.S. citizens. Moreover, no problem is foreseen with the commitment made by present U.S. flag vessels to the Sealift Readiness Program. These vessels meet the current citizenship requirements in order to be under U.S. flag and they operate with U.S. citizen officers and crews.

The second change would require that carriers have one year of operational liner experience to be eligible to receive an award from MSC. This would have a drastic effect on new enterprise, initiative and economy, thereby having an adverse impact on the American merchant marine and increasing ocean transportation costs to DOD. Existing carriers, particularly large established carriers, would be favored, and new U.S. flag entrants into the trades would be discouraged and disadvantaged. This is particularly important in view of the heavy reliance all U.S. flag carriers place on the carriage of military cargoes to remain viable.

The Navy's policy is to do business in the same manner, to the extent possible, as the other commercial users of ocean liner service. In the commercial sector there is no requirement for a carrier to demonstrate operational liner experience to be eligible to file a commercial tariff and commence service in the U.S. foreign or domestic ocean commerce of the United States. Similarly, it is unnecessary to invoke a restrictive one year operational requirement for the transportation of DOD cargo which is carried in these same commercial ships. Before award of a contract, the Contracting Officer must determine that an offeror is capable of performing the service offered. All offers are carefully reviewed to determine whether offerors have control of the necessary U.S. flag ships and equipment to successfully perform the contract. The Contracting Officer also evaluates the demonstrated experience of individuals in the company to ensure they have the necessary expertise to manage a shipping company properly. Those individuals could have one-hundred years or more of combined maritime experience, but, under Mr. Baker's proposal, their company could not bid on MSC contracts until the company had been in business for over one year. Imposition of this type of restriction on an entire industry is unprecedented in any other area of Government procurement, including the manufacture of weapons systems and research and development.

Moreover, there is no evidence to support Mr. Baker's allegations that without a one year operational requirement new operators will submit artificially low bids, forcing bona fide carriers to make less profit. One would presume that just the opposite would occur. The start-up costs and high cost of capital would likely require new carriers to quickly amortize significant non-recurring costs, thus initially causing the rates bid to be higher than rates of established companies.

Harbridge House was tasked by MSC to conduct a study of the impact of MSC's procurement policies and practices and the effect of implementing the changes suggested by the Commission on Merchant Marine and Defense and industry officials. Harbridge House concluded that rates paid by DOD for liner services track the overall supply-demand balance in the relevant trades, and are consistent (within 5%) with commercial rates paid by volume shippers using service contracts permitted under the Shipping Act of 1984. The concern of Mr. Baker that speculators will drive the rates artificially low forcing ocean carriers to offer rates below cost is without foundation. Rates are offered by carriers to MSC for carriage of DOD cargo on the basis of a full and open competition, on whatever trade routes they wish to serve. Such rates reflect the conditions of the marketplace.

The third "reform" recommends penalizing carriers that fail to initiate service after being selected for award of a contract or

requiring bid guarantees or performance bonds. According to Mr. Baker, this will prevent speculators not committed to performance from artificially driving down bid prices.

This recommendation is based upon the contention that an offeror would go to the trouble and expense of analyzing a Government solicitation, entering into negotiations and submitting a bid, without any intent of providing service, but rather with the hope that other carriers will react by lowering their bid prices which in turn would cause them financial hardship. Currently, carriers independently offer rates and service on the routes they wish to serve and are required to commence that service by a specific date. If an offeror fails to so commence service, it is not entitled to carry Government cargo on that route for the remainder of the period covered by the solicitation. When service is not maintained under our agreements, the Contracting Officer cancels the rates of that carrier in their entirety or on a specific route. This is similar to commercial practice whereby a carrier is permitted to discontinue service and cancel its tariff at any time. In accordance with standard procurement practice, carriers are subject to termination for default and the assessment of excess reprocurement costs for failure to perform pursuant to the terms and conditions of the contract.

With regard to the use of bid guarantees or performance bonds to secure performance, under the Federal Acquisition Regulation such guarantees are not favored, except for construction contracts. For other contracts, performance bonds may be required only under limited circumstances, such as where Government property or funds are to be provided to the contractor or substantial progress payments are to be made before delivery. The regulations recognize that bid guarantees and performance bonds cost the contractor substantial sums, and that those costs will be passed on to the Government. Bid guarantees or performance bonds are not free, and the regulations confirm that they are not justified for ocean and intermodal transportation services. In addition, new entrants in the field normally would have a more difficult time securing a bond and would pay more for it. This would be yet another unnecessary and restrictive hurdle placed in the path of new investors. The maritime industry is capital intensive. It steadily consumes capital in vast amounts in order to remain competitive and grow. Accordingly, any weakening of investor access to any market, especially the carriage of DOD cargo, will depress overall investment and further erode the number of American flag ships and jobs for U.S. citizen crews.

In his fourth recommendation Mr. Baker suggests that MSC reduce the maximum share of cargo which may be carried by the low bidder on certain trade routes. Based on experience, the various carriers serving the trade have capacities that exceed the maximum

percentages recommended by Mr. Baker. Therefore, this provision would act to limit the amount of cargo that the low cost carrier would be eligible to carry on a route. With increasing concentration of the U.S. flag liner industry, there are relatively few bidders with significant capacity to compete for MSC cargo in any given trade. In a bidding competition with few bidders and reduced maximum percentages, the incentive for each carrier would be to bid high rates, because each carrier would essentially be guaranteed a percentage of the cargo. Thus any reduction in the share of MSC cargo which may be carried by any one carrier creates a disincentive that leads to higher Government costs. Larger companies would, of course, have the most to gain by such an arrangement because they could gain greater profits from carrying reduced amounts of cargo.

The fifth suggestion is to recognize a carrier's excess level of voluntary commitment to the Sealift Readiness Program through payment of the prices bid plus an additional amount for each ton of cargo transported. This is simply a subsidy, payment of which would not increase the number of militarily useful vessels in the U.S. flag liner fleet and only serve to increase the cost to the taxpayers.

The last recommendation is that MSC strengthen its policy of using commercial liner service rather than chartered vessels. It is DOD's long standing policy to use commercial liner service for the transportation of DOD cargo whenever possible. MSC operates a minimum number of U.S. flag time chartered vessels necessary to provide cargo lift capability which is not available from commercial liner operators. More than 80 percent of DOD dry cargo tonnage is being moved on commercial liner ships annually. The remainder moves in commercial vessels chartered to MSC as the cargo they carry is not suited to liner service, based on factors such as type of cargo, volume, destination, and delivery requirements. In summary, all MSC cargo moves in privately owned U.S. flag vessels, and no cargo moves in Government owned ships.

I hope that these comments will provide the subcommittee with a better understanding of the issues as they relate to the changes proposed by Mr. Baker.

DEPARTMENT OF THE NAVY
COMMANDER MILITARY SEALIFT COMMAND
WASHINGTON, D.C. 20398-5100

IN REPLY TO

24 JUN 1988

(24 Jun 1988)

Mr. Joseph Walsh
U.S. General Accounting Office
NSIAD Audit Site
Crystal Gateway III
1215 Jefferson-Davis Highway
Arlington, VA 22202

Dear Mr. Walsh:

During your visit on 18 April 1988 to MSC Headquarters, you submitted nine questions regarding certain MSC policies and procedures with respect to the U. S. Merchant Marine. The command's responses to the questions are enclosed.

The responses are complex and require study in order to gain a full understanding of their meaning; fractionating portions of the responses would result in less than accurate response to the questions posed.

Sincerely,

W.T. PIOTTI, JR.
Vice Admiral, U.S. Navy

Enclosure

(W. T. PIOTTI, JR.
Vice Admiral, U.S. Navy)

(Enclosure to MSC letter to GAO, dated 24 June 1988)

MSC POSITION ON ISSUES IMPACTING
THE U.S. MERCHANT MARINE

1. A major steamship company has advocated the following with regard to awards for military cargo. Please comment on these views.

a. In a trade route when there are three or more bidding carriers, the number one carrier would get first call on 50% of the cargo and the remaining carriers would split the other 50%, provided they "me too" the winning carrier's rates.

ANSWER: This proposal would clearly violate the statutory requirements for full and open competition, discussed more fully in the response to question 2 below. Specifically, no carrier would have the incentive to offer its best rates, as each would be assured of a substantial volume of cargo regardless of the rate. As a result, each carrier would bid high, increasing very significantly the government's transportation costs. Further, the proposal is overly simplistic in that it assumes that all carriers are equal in terms of service and capacity. In fact, there is wide variation among carriers. Thus, if one of three carriers bidding on a route could handle only 30% of the cargo and the next as much as 50% of the cargo, there is actually an incentive for each carrier to bid as high as possible. Accordingly, in the best interest of the Government, MSC must oppose this suggestion.

b. The shipping cycle should be valid for a year instead of the present six months.

ANSWER: When MSC instituted competitive procurement in 1966, the rates offered by carriers were effective for one year. In response to comments from the carriers that the cycle was too long, MSC shortened the period of the rates ("the cycle") to six months in 1971. Other changes to the system were also made at that time. MSC believes that the six month cycle continues to offer several advantages, both to carriers and the Government: (1)it enhances competition by permitting periodic adjustments in rates to meet changing world economic conditions, as well as domestic and international trade conditions; (2) it provides greater flexibility to carriers for adjustments in operating and maritime cost factors, shifts in the balance of trade, and other changing world competitive conditions; and (3) it gives carriers the opportunity to improve their relative standing in the "pecking order" of rate favorability for the carriage of DOD cargo.

c. The practice of asking for best and finals should be eliminated and rates should be filed at one time as close as possible to the end of the current cycle.

ANSWER: This is in essence a proposal to go to a sealed bid procedure and is discussed in number 2 below.

2. Please discuss the advantages and disadvantages of an "Invitation for Bids" in lieu of a "Request for Proposals" rate solicitation for cargo.

ANSWER: The procurement of ocean transportation services for the Department of Defense (DOD) in the foreign commerce and domestic offshore trade of the U.S. is governed by the Armed Services Procurement Act, 10 U.S.C. 2301, as amended by the Competition in Contracting Act (CICA), P.L. 98-369, and as implemented by the Federal Acquisition Regulations (FAR). The two primary competitive procedures specified in CICA to accomplish "full and open competition" are sealed bidding, as specified in 10 U.S.C. 2304(a)(2)(A), and competitive proposals (negotiation) as per 10 U.S.C. 2304(a) (2) (B). Solicitations for the procurement of supplies and services under a sealed bidding process (FAR PART 14) are referred to as Invitations for Bids (IFB). Solicitations for the procurement of supplies and services under a negotiated contracting process (FAR PART 15) are referred to as Requests for Proposals (RFP).

Under the FAR, it is the responsibility of the Contracting Officer to select the method of contracting that best suits the needs of the Government. Therefore, the type of competitive procurement process to be used depends on the nature of the services being sought. In this regard, CICA at 10 U.S.C. 2304(a)(2), and as implemented by the FAR at Part 6.104, sets forth the criteria for using an IFB, sealed bidding process. Sealed bidding shall be used if (1) time permits the solicitation, submission, and evaluation of sealed bids; (2) the award will be made on the basis of price and other price related factors; (3) it is not necessary to conduct discussions with responding sources about their bids; and (4) there is a reasonable expectation of receiving more than one sealed bid. The Contracting Officer shall request competitive proposals, i.e., proposals subject to negotiated procurement, if sealed bids are not appropriate.

Negotiated procurement (10 U.S.C. 2305(b)), and sealed bidding are significantly different procurement processes. The essential element that makes a sealed bidding process inappropriate for the procurement of ocean transportation services is the lack of flexibility and discretion afforded the Contracting Officer to exercise business judgment in making an award, and concomitantly, the

inability to conduct discussions with offerors. In sealed bidding, for a bid to be "responsive" and considered for award, it must comply in all material respects with the IFB. If an offer is "non-responsive", MSC would be required to reject the offer, without discussion, at the time of bid opening. FAR 14.404-2(a) states that "any bid that fails to conform to the essential requirements of the solicitation shall be rejected", and it is immaterial whether the non-conformity occurs by design or mistake, or whether the bidder is willing to modify the bid to conform to the terms of the invitation.

Conversely, in negotiated procurement, the Contracting Officer is not required to reject proposals which vary from the requirements of the RFP. Instead, the Contracting Officer may include offerors' proposals that can be made acceptable. Alternatively, in negotiated procurement, the solicitation may be amended, after negotiations, to clarify or change requirements. Thus, the concept of "responsiveness", as developed in sealed bidding, and which prohibits the Contracting Officer from considering a bid which deviates from the IFB, is not applicable to negotiated procurement.

Under each of the current negotiated procurements, numerous rates and services are requested from and submitted by each offeror. Due to the complexity of these rate solicitations for cargo, complete material compliance with the solicitation can be difficult. It is not uncommon for MSC to receive proposals which contain mistakes, or proposals which offer a service that cannot be fully performed with the assets proposed. Under a negotiated procurement, following negotiations, a carrier in its best and final offer may correct a mistake or modify its offer of service in relation to its assets.

The FAR also requires the Contracting Officer to make an affirmative finding of responsibility before awarding a contract. Under sealed bidding, an offeror's ability to meet the requirements of the FAR regarding "responsibility" to the satisfaction of the Contracting Officer may be severely restricted. In sealed bidding, questions of responsibility are determined primarily on the basis of all the information submitted or available, up to the time of award. Where the Contracting Officer has doubts as to whether the bidder will be able to perform in accordance with the IFB, the Contracting Officer has only limited ability to seek additional information to satisfy his concerns. Under a negotiated procurement, the Contracting Officer can advise all offerors during discussions of the standards which each must meet in order to permit an affirmative finding of "responsibility" prior to award. This clearly maximizes competition for the Government from small and large operators alike.

A negotiated procurement is also in the best interest of the Government in order to ensure compliance with the Cargo Preference Act of 1904. The Cargo Preference Act of 1904, 10 U.S.C. 2631 states in pertinent part that:

> Only vessels of the United States or belonging to the United States may be used in the transportation by sea of supplies bought for the Army, Navy, Air Force or Marine Corps...Charges made for the transportation of those supplies by those vessels may not be higher than the charges made for transporting like goods for private persons.
> (Emphasis added.)

MSC's obligation, therefore, under the 1904 Act is to protect the Government's interest in paying reasonable rates for ocean transportation services. Under a sealed bidding process, the Contracting Officer does not have the ability to discuss the level of rates offered. As a result, MSC would be required to reject an offer containing rates which are submitted by a carrier which violate the standards set forth in the 1904 Act, without the opportunity for the carrier to reconsider its rates and modify them in a best and final offer. Considering the nature and the extent of the services being sought, it is, therefore, clearly in the best interest of the Government and the carriers to employ a competitive proposal/negotiated procurement method.

3. What are MSC's views on the use of a system such as the one presently being used by the Military Airlift Command for the transportation of government cargo.

ANSWER: Both the Navy's Military Sealift Command (MSC) and the Air Force's Military Airlift Command (MAC) methods for procuring transportation are governed by the Armed Services Procurement Act , as amended by CICA, and as implemented by the FAR. Both methods also recognize the need for augmentation of organic fleets in situations short of full mobilization. However, there are very basic differences in requirements and, therefore, there are differences between the procedures used by MSC and MAC for procuring space from ocean carriers and air carriers, respectively.

The Navy's procurement method is based on four premises:

a. In compliance with CICA, the Navy's policy is that, like other services, ocean transportation will be procured on the basis of full and open competition. The only modification to this fully competitive policy applies to liner cargoes where certain maximum percentages of cargo limits have been imposed to ensure the long term viability of at least two companies on selective trade routes.

b. The second premise is that the Government should do business in the same manner, to the extent possible, as the other commercial users of ocean liner services. Commercial shippers pay the market rate based on conditions of supply and demand, and fluctuations in the rate of foreign exchange. The Government ocean shipper negotiates on the same basis.

c. The third premise is that pursuant to Section 101 of the Merchant Marine Act of 1936, 46 U.S.C. 1101, the Maritime Administration (MARAD) is responsible for promoting the Merchant Marine. While the Navy strongly advocates a robust U.S. flag merchant marine, MARAD is the agency responsible for promoting its health and welfare. MARAD provides subsidies to offset higher U.S. wages and costs so that U.S. flag carriers may remain competitive in the international market. In addition, there are various cargo preference laws which provide advantages for U.S. flag carriers over foreign competitors in the form of the carriage of DOD cargoes outbound to help balance their voyages.

d. The last premise is that the Navy has channeled all military cargo to commercial carriers, and will continue to do so. There are no Government owned dry or liquid cargo ships in MSC's fleet engaged in point-to-point service. More than 80% of DOD dry cargo tonnage is being moved on commercial liner ships annually. The remainder of DOD cargo is moved in U.S. commercially chartered vessels.

To implement its procurement system, the Navy solicits rates semiannually for both breakbulk and container service from ocean common and contract carriers. In connection with their container services, carriers also offer numerous joint through rates with participating inland carriers between various inland points in the U.S. and various overseas inland points. MSC awards contracts, similar to a requirements contract, to all technically acceptable and responsible carriers which offer rates, and as a condition for award, carriers are required to agree to commit half of their ships

to the Navy's Sealift Readiness Program. As ocean shipping requirements arise, cargo is booked, in descending order of cost favorability to the Government, to the carrier whose service best meets the specific requirements of the cargo at the least cost.

Similar to the Navy program, the cornerstone of MAC's Civil Reserve Air Fleet program (CRAF) is the allocation of cargo in exchange for a carrier commitment of airplanes, to be called up by DOD. However, unlike the Navy's procurement method, MAC utilizes a formula to determine the mobilization value of the aircraft committed. This process is facilitated by the fact that most airlines use the same types of aircraft, the large passenger types most needed by MAC in a crisis. The maritime industry, on the other hand, stands in marked contrast. The very types of vessels which DOD will need most in an emergency such as lighter aboard ships (LASH), roll-on/roll-off, and breakbulk ships, are the least efficient commercial ships. Conversely, the most efficient commercial ships are large non self-sustaining container ships, which are the least militarily useful ships in a crisis. (It should be noted that MAC is facing a similar problem. Commercial airlines are shifting to smaller, more efficient aircraft which are less militarily useful than the 747's around which the program has been built.)

There are other significant differences between Navy and MAC methodologies and practices which illustrate the fact that the MAC system is not applicable for the procurement of ocean transportation services for DOD. The Navy relies on the liner segment of the U.S. merchant marine to transport about 7 million measurement tons (one MT=40 cubic feet) of military cargo annually during peacetime. Most of this cargo is transported in less than shipload lots and is of a continuous regular nature to support troops overseas. It is ideally suited for the regularly scheduled berth liner service offered by U.S. flag ocean carriers. MAC, on the other hand, ships a fraction of that tonnage as "channel cargo" annually with U.S. flag commercial airlines. "Channel cargo" is all cargo, other than passengers, moving in regularly scheduled service to previously established destination points. MAC meets its channel cargo requirements through either Air Force owned aircraft or charters of entire aircraft for short periods (similar to maritime voyage or spot charters). Scheduled airlines frequently have the ability to make their aircraft available for these short term charters which can be accomplished in a day or two. Regularly scheduled ocean carriers do not have that flexibility. Accordingly, MSC operates a small number of U.S. flag time-chartered commercial dry cargo ships, contracted for under full and open competition, to provide this capability which is not available from berth liner operators. Short term voyage/spot charters for ocean movement of dry cargo are rare.

Additionally, there are differences in ratemaking authority. When the Air Force CRAF program began in the early 1950's, the Civil Aeronautics Board (CAB), established minimum rates using cost data submitted by the carriers. The CAB had authority to establish just and reasonable rates under the Civil Aeronautics Act of 1938, 49 U.S.C. 1301. Now that the CAB has been abolished, MAC itself establishes the rates using the ratemaking principles formerly used by the CAB. The carriers furnish cost data to MAC pursuant to a Memorandum of Understanding, and available peacetime cargo is allocated to each participating carrier in proportion to its commitment to the CRAF program. This system appears to be workable for MAC where the carriers each offer the use of similar equipment, the method of operation is similar, the tonnages moved, although limited, fill out the aircraft's capacity, and the service is strictly a point to point service with no provision for joint through rates with inland carriers.

In contrast, regulation of ocean transportation has historically been governed differently by design. There is purposely no provision for governmental setting of rates in the foreign ocean commerce of the U.S. The Federal Maritime Commission (FMC), charged with regulating the foreign ocean commerce of the U.S., does not have and has never had ratemaking authority in foreign commerce under the Shipping Act of 1984 (46 U.S.C. app. 1701 et seq.), or its predecessor the Shipping Act of 1916 (46 U.S.C. 801 et seq.). The Shipping Act of 1984 also deregulates ocean carriers in foreign commerce through such mechanisms as service contracts, loyalty contracts, and expanded independent action authority. Setting rates in foreign commerce would be extremely complex and burdensome. It would promote inefficient operations, and result in substantially higher rates overall to compensate for the weaker, inefficient carriers.

During 1971-72, the Sealift Procurement and National Security Study (SPANS) was conducted by senior members and staff of the Office of Management and Budget, DOD, MARAD, FMC and industry representatives in response to allegations, similar to those now being made, that the DOD procurement system had forced ocean carriers to offer rates below costs. The study found that overall, DOD cargo was compensatory. Subsequently, the FMC performed numerous investigations of the rates charged for carriage of DOD cargo to determine whether such rates were too low under the standards of the Shipping Act of 1916. No rates were ever found to be noncompensatory and rates were never disapproved.

The philosophy of the Shipping Act of 1984, which repealed the provision under which FMC investigated DOD rates, is to replace government regulation with regulation by competitive forces of the market place. The Navy's procurement system is fully consistent with

this philosophy of full and open competition, which has historically provided the key to U.S. growth and prosperity. Through competition, the U.S. industrial base will be strengthened for a stronger and more affordable national defense.

As stated by Mr. Verdon, President of the United Shipowners of America, before the Commission on Merchant Marine and Defense on May 23, 1988, the current system used for solicitation of DOD cargo is "an extremely complex issue and quick answers may well cause more problems than already exist." MSC submits that this is a sound philosophy to be applied to any analysis of the applicability of the MAC system to MSC.

4. What is MSC's position regarding the recommendation by the Commission on Merchant Marine and Defense to change the method for solicitation for procurement of ocean transportation services to a stable rate system based on established tariff rates used by commercial shippers.

ANSWER: As stated in the answers to similar questions, MSC does not agree with the Commission's recommendation to shift to an established tariff rate system for the carriage of DOD cargo. Rates are offered by the carriers to MSC for carriage of DOD cargo on a full and open competition basis on whatever trade route they wish to serve, and such rates reflect the conditions of the marketplace and, at a minimum, cover the carriers' incremental costs. Use of the recommended tariff system would disadvantage the Government relative to commercial shippers in that it would result in nigher costs to DOD compared to equivalent service for commercial shippers. Further, at a Federal Maritime Commission sponsored industry conference held in Long Beach, California, 18-19 February 1988, senior officials of the major U.S. flag and two major foreign flag carriers, as well as academicians, attributed the industry problems to overtonnaging on major routes, encouraged by banks, shipyards, foreign governments, and the imbalance of trade. U.S. carrier officials did not include DOD procurement policies, practices, and rates as even a factor in the industry's decline.

5. In a letter dated April 30, 1986, (sic.) to Mr. Frank Drozak the transportation of government cargo was discussed. Is the position of MSC, as expressed by Admiral Piotti in this letter still valid?

ANSWER: The position of MSC as stated in Admiral Piotti's 30 April 1987 letter to Mr. Frank Drozak with regard to the transportation of government cargo has not changed and remains valid. The other issue addressed in the letter, General Agency Agreements, is no longer pertinent.

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6. A concept has been discussed within the Navy whereby, if the Government is the low offeror in an A-76 competition, the low commercial offeror might be accorded the opportunity to operate the competed ships at the Government's bid price plus appropriate cost adjustments. Please discuss the advantages and disadvantages of this concept and MSC's opinion of the desirability of implementation, also:

a. What revisions to existing OMB A-76 rules would be required to implement the proposal?

b. What safeguards would be necessary to prevent a government entity from deliberately lowballing its offer in order to preclude a commercial offeror from accepting such an opportunity?

ANSWER: The concept of allowing the low priced technically acceptable commercial offeror to operate MSC vessels competed under OMB Circular A-76 (A-76), if the commercial offeror is willing to operate the ships at the Government's bid price plus an appropriate cost adjustment, was discussed within the Navy as a means of alleviating some of the advantages which accrue to the Government through application of the A-76 rules and cost comparison process. Maritime industry representatives have complained that certain aspects of the A-76 cost comparison process unfairly favored continued governmental operation of the function under study. For example, the industry representatives said that the costing of liability insurance and quality assurance functions favored continued government operation. Profit, cost of capital, self insurance were among other aspects of the A-76 rules discussed.

The main advantage of this concept is that it would promote the fundamental government policy of maximum reliance on the private sector. The chief disadvantage is that the operation of the ships will not be at the lowest cost. This concept cannot be implemented without a major revision of OMB Circular A-76 and possibly changes to the Federal Acquisition Regulations and the Competition in Contracting Act. No special safeguards would be necessary to prevent the government from "lowballing" its estimates since the government would be forced to operate the ships at that cost if a contractor declined to do so.

Since this concept was developed, the President's Commission on Privatization has held 12 public hearings, one dealing specifically with A-76 issues. The issue of equitable treatment has been raised in these forums by both the private and public sectors. Both perceive inequities in the process. The Commission concluded, however, that despite problems in particular instances, the process is generally

beneficial and should be pursued aggressively. In short, it is impossible to equalize all disparities. Each side in the competition has inherent advantages and disadvantages. The successful competitor maximizes the former and minimizes the latter.

The government-wide experience with A-76 studies has been that about half the functions are contracted out and half retained in government. Interestingly, this has been the MSC experience as well. Since January, 1984, MSC has studied 24 ships under A-76; 12 were contracted out and 12 were retained in house as a result of these studies. This indicates a basic equity in the overall process in that it does not favor one side consistently to the detriment of the other.

7. Please discuss what changes in a Request for Proposals (issued in an A-76 competition) are necessary in order to authorize a revision in the Government's offer after the date initial offers are submitted. (OPNAV Instruction 4860.7B, Paragraph 475.A.2)

a. Given that a change in the RFP is sufficient to authorize a revision of the Government's offer, to what extent may that offer be revised; i.e., may it be revised only as necessary to respond to the specific change(s) in the RFP?

b. How do "revisions:" allowable under Para. 475 of OPNAVINST 4860.7B differ from "corrections" allowable under Para. 476? Please discuss this subject within the context of the recent cable ship award.

ANSWER: Paragraph 475.A.2 of OPNAV Instruction 4860.7B sets forth the rules concerning changes to the MEO and the Government cost estimate after initial offers are received in an A-76 cost comparison which is conducted via the negotiated procurement. The regulation provides that:

> Changes may be made to both the MEO and the Government Estimate up to the date proposals are received. After this time, changes may be made only if amendments to the solicitation, during the negotiation process, change the performance requirements identified in the PWS. In such cases, the Government estimate should be withdrawn, revised to reflect the changed requirement, recertified by the reviewing official, and resubmitted to the Contracting Officer by the date established for the receipt of

> amended proposals. No other changes are permissible prior to the announcement of the results of the comparison. In many cases, changes to Government policy will include a "grandfather" clause. In such cases, incorporation of the latest changes may not be required. Any required changes should be made after bid opening (See Section 476). If it appears prior to the comparison and announcement of the results that a required change may materially affect the outcome of the comparison, the activity should submit an amended cost estimate. This estimate should identify all changes made, cite the rationale and the requiring directive, and should contain the work papers showing all computations resulting in the change. Copies of the amended estimate with the original estimate should be available for all interested parties when the results are announced.

This regulation allows the Government to revise its cost estimate after the receipt of initial proposals whenever a solicitation is amended to change, in any manner, the requirements set forth in that solicitation. The regulation permits the Government to revise any item in the MEO or the cost estimate which is affected by the change to the solicitation either directly or indirectly. The extent of the revisions to the cost estimate which are permissible will naturally depend on the magnitude of the changes to the solicitation set forth in the Amendment. The revisions must also be sufficient to allow the Government to certify that the MEO and the cost estimate will allow the Government to operate the activity in the most cost efficient and effective manner possible in accordance with the terms and conditions of the amended PWS. The revisions to the cost estimate must be made to such an extent to allow such a certification.

Paragraph 476A of this OPNAV Instruction deals with corrections to the in-house cost estimate after bid opening. This section states that:

> A. Periodically, CNO (OP-443) will publish updated inflation indices for use in cost comparison studies. Cost estimates should use inflation indices in effect at the time immediately prior to their audit. Inflation indices issued after the commencement of the audit will not, in most instances, materially affect the outcome of

the cost comparison; therefore, the Government estimate should not be recalculated prior to bid opening. If, after bid opening, it appears that application of latest inflation indices might materially affect the outcome of the cost comparison, the major claimant is to review the cost comparison and, if warranted, direct recalculation using inflation indices in effect at bid opening. In such instances, new indices should be applied to various cost elements at the largest aggregate level.

B. Other computational vice judgmental corrections may be made after bid opening. These corrections would be made when it appears that the change might materially affect the outcome of the cost comparison. They would be derived from such factors as changes in fringe benefit rates and annual work hours. The major claimant will direct recalculation as warranted.

C. Advise independent review of changes made.

The corrections which must be made after bid opening differ from those which may be made after receipt of initial proposals. These corrections do not result either directly or indirectly from an amendment to the solicitation and are changes that are either mathematical or computational in nature or simply result from changes to such things as inflation indices.

The differences between allowable changes which can be made to the cost estimate pursuant to these two sections of the Circular is evident in the recent cable ships cost comparison. In that comparison, the Government recalculated certain aspects of its cost estimate after the receipt of initial proposals due to several amendments to the cable ship solicitation. In accordance with the Circular, MSC's cost estimate of September 1986 for the operation and maintenance of the cable ships was completed, reviewed, audited and submitted to the Contracting Officer in a sealed, dated envelope prior to 19 September 1986, the date set for receipt of initial proposals. Subsequently, Amendments 9 through 12 to the solicitation were issued. These amendments significantly changed the requirements of the PWS by breaking the ships into two lots, changing operational schedules and delivery dates for the vessels, and requiring substantial government furnished familiarization both ashore and at sea. The ships were

divided into two lots and the familiarization program was established because none of the offerors demonstrated that they could satisfy the experience requirements for the strategically vital mission of the cable ships. Without these changes, no award could have been made as no technically acceptable initial proposal had been received and the procurement would have been cancelled. The extensive changes set forth in these amendments after initial proposals were received obviously required that MSC revise the cost estimate to reflect these new requirements. OPNAVINST 4860.7B and the Circular require that the Agency develop the most efficient and cost effective in-house organization to accomplish the requirements in the PWS. The Agency must also certify that the most efficient organization is used as the basis for the cost comparison. Without the revisions to the cost estimate to reflect the new requirements set forth in the Amendments to the solicitation, this certification could not be made. Section 502 of the 1981 Department of Defense authorization Act, P.L.96-342, requires that no commercial or industrial function of the Department of Defense which is being performed by civil service employees on 1 October 1980 (which encompasses the cable ships) may be converted to commercial performance unless the Secretary of Defense certifies to Congress: that the government calculation for the cost of performance of such function by Department of Defense personnel is based on an estimate of the most efficient and cost effective organization for the performance of such function by Department of Defense personnel... (emphasis added).

MSC's decision to recost several aspects of its cost estimate was proper given the peculiar circumstances of the procurement, specifically, the long delay between the time of the submission of initial offers and the cost estimate and the issuance of the amendments which necessitated the recosting; the fact that the original MEO specifically recognized the potential for the reduced level of overtime; the fact that the procurement was previously cancelled; and the requirement of Section 502 of the Authorization Act, set forth above, that the cost estimate be based on the most efficient and cost effective organization. Moreover, given these changes to the RFP, MSC could have cancelled the solicitation and issued a new Request for Proposals. In fact, this option was discussed and carefully considered. MSC was aware, however, of the hardship and additional cost and effort that cancellation would cause if the offerors' efforts to date were for naught and the offerors had to begin again with a new procurement. If the RFP was cancelled, however, the government also would have begun anew, preparing a new Management Efficiency Study and a new Cost estimate. The Government would have been free to make any changes appropriate to ensure that its estimate was based on the most efficient and economical organization. From all perspectives it appeared that the best course was to proceed with an amended Request for Proposals with all

parties able to adjust their estimates according to the latest requirements and factors. It is interesting to note that the Government estimate was substantially lower than the $53,308,957 offered by the low commercial offeror. The initial Government estimate prepared in September 1986, prior to the revisions, was $47,663,565. Had this estimate been adjusted only by the changed cost factors, it would have been $45,551,902. With the additional change resulting from the inclusion of the overtime study the Government estimate is $41,956,182. The operation of the cable ships would have remained in house no matter which Government estimate was used. By using the lowest estimate, which included the overtime study, the taxpayer ultimately benefited.

The MEO issue paper, prepared in connection with the original Government cost estimate of September 1986, recognized that overtime levels could be reduced through managerial improvements and that a study should be conducted to quantify any resulting savings. However, since no study was completed when the original cost estimate was prepared, the overtime element of the cost estimate was based on historical data from the nucleus ships expense reports. The overtime study was completed and was included in the revised MEO which was approved in April 1987. The Government's revised cost estimate reflects the conclusions of that study.

Based on the large volume of changes set forth in Amendments 9 through 12 to the cable ship solicitation, and the fact that MSC is statutorily required to make certain that its cost estimate is based on the most efficient and cost effective organization possible, various changes were made to the Government's cost estimate after receipt of initial proposals. The commercial offerors were free to make any changes they desired in their best and final offers. The changes made by the Government were in response to the above quoted statute and did not ultimately affect the outcome of the cost comparison.

8. Discuss how the costs of civil service mariners in the Marine Placement and Receiving Branches (MP&RB) are included in MSC's A- 76 cost calculations for operation of MSC vessels.

MSC civilian mariners in a pay status are always in one of the following categories: (1) assigned to a ship; (2) on paid leave of some type; (3) awaiting assignment in the shoreside pool; or (4) in training. The civil service mariners in the Marine Placement and Receiving Branches have received a civil service appointment but are not currently assigned to a ship. However, all costs for mariners in

the MP&RB are incorporated in the Government's cost estimate. More specifically, costs for leave are included in line 1, costs for awaiting assignment are included in line 4, and costs for training are included in line 3 of the Government's in-house bid.

Historical data, adjusted for MEO reductions, is used as a basis for computing the costs for mariners in the MP&RB (leave, awaiting assignment and training). The Naval Audit Service and Chief of Naval Operations (OP-443) have consistently approved MSC's costing/methodology for accounting for these costs.

9. An activation history of Ready Reserve Force (RRF) ships from October 1977 to February 1988 shows 42 activations. Of these, the operational use for 18 ships ranged from 62 to 342 days. Please discuss MSC's position on the use of RRF ships for extended periods of time. Does MSC plan to continue operation of RRF ships for similar periods in the future?

ANSWER: Activations should be of sufficient duration to ensure RRF readiness and to validate maintenance performed during inactivation. Extended activations, such as those experienced with CAPE DECISION and CAPE DOUGLAS in 1986, were the result of a need to sequentially support a number of successive exercises, and a paucity of funding to conduct alternate or additional activations. The extended breakout of CAPE HORN in 1987 was driven solely by the length of Exercise Team Spirit. In addition, only exercise cargo is carried during these breakouts, and as has been stated earlier, <u>all DOD point-to-point cargo moves</u> in U.S. flag commercially owned vessels.

MSC does not, at this time, foresee the need for extended activations in the future. MSC believes short term activations, coupled with the use of commercial or controlled fleet assets, will be sufficient to meet JCS and other exercise requirements. Procedures regarding the use of activated RRF ships has been addressed in the new MOU between MSC and MARAD which reflect the stated position.

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

INSTALLATIONS AND LOGISTICS
TS

27 APR 1966
(27 April 1986)

File
Wilson Weeks agreement

MEMORANDUM FOR THE COMMANDER, MILITARY SEA TRANSPORTATION SERVICE

SUBJECT: Defense-Commerce Agreement on utilization of privately-owned ships (Wilson-Weeks Agreement)

In response to your request of April 4, 1966 we are attaching a statement of the Department of Defense position on priorities under the Wilson-Weeks Agreement.

R. C. Moot

Attachment

ROBERT C. MOOT
Deputy Assistant Secretary of Defense
(Logistics Services)

91-503 O - 89 - 6

DOD POSITION ON PRIORITIES UNDER THE WILSON-WEEKS AGREEMENT

The pertinent portion of the Wilson-Weeks Agreement provides:

"4. c. All merchant shipping capability required by the Department of Defense, in addition to that provided by the MSTS nucleus fleet, will be obtained, consistent with military requirements and prudent management, in the following order of priority:

(1) Maximum utilization of available U. S. flag berth space.

(2) Time or voyage charter of suitable privately-owned U.S. flag merchant ships to the extent these are voluntarily made available by the maritime industry. Such time or voyage charters will be kept to the minimum necessary to meet requirements which foresight indicates cannot be met by U. S. flag berth operators.

(3) Shipping provided by National Shipping Authority under General Agency Agreement or other arrangement, or

(4) In the event suitable U.S. flag shipping is not available under the conditions stated above, the Military Sea Transportation Service may employ foreign flag shipping only to the extent necessary to meet urgent military requirements."

It is the view of the Department of Defense that present MSTS procurement and operating procedures are consistent with these provisions.

MSTS today does not seek a chartered ship unless reasonable foresight indicates that there will be insufficient berth space available. Similarly, ships are not requested from the Maritime Administration unless there is good reason to anticipate that both berth and chartered shipping together will not provide adequate space. Foreign flag ships are used only in extreme cases with each use limited to a specific cargo.

Once MSTS has acquired a time or voyage chartered U.S. flag ship prudent management requires that it be utilized to the extent possible. For example, if retrograde military cargo were available and could be booked to either a berth line ship or a chartered U.S. flag ship returning to the United States, it would be reprehensively wasteful for MSTS to book the cargo to the berth ship merely to provide additional revenue to the liner company. Similarly, with suitable charter and berth capability available for outbound cargo, it would be wasteful to incur berth line costs when we must continue the charter through the contract period.

The same application of prudent management is made for General Agency Agreement ships. As long as we see a continuing need to supplement berth and chartered shipping with GAA ships, it would be wasteful to let the ship sit idle in port with crew and other costs continuing.

In the case of CAA ships, however, it is and will be our policy to return ships to the Reserve Fleet as soon as it becomes evident that the continuing need is diminishing.

We do have a degree of flexibility in employment of nucleus fleet and CAA ships. In times of shipping shortage useful but non-essential repairs are often deferred. In times of temporary ship surplus it is prudent to make these repairs and perhaps to advance overhauls originally planned for later. Such use of periods for repair has the effect of giving to berth line cargoes which the government ships could have carried if they remained on their original schedules. We do not have this flexibility with chartered ships since the timing of repairs is a matter for decision by the ship owner.

The policy as outlined above was followed during the Korean War.

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MEMORANDUM OF AGREEMENT BETWEEN THE DEPARTMENT OF DEFENSE AND THE DEPARTMENT OF COMMERCE DEALING WITH THE UTILIZATION, TRANSFER AND ALLOCATION OF MERCHANT SHIPS - 1 JULY 1954

1. Cancellation:

This memorandum cancels and supersedes the Memorandum of Agreement between the Department of Defense and the Department of Commerce signed in August 1951.

2. General:

a. The Department of Defense and the Department of Commerce agree that, for the national defense, they have complementary interests in the control and utilization of ocean-going merchant ships.

b. The Departments also agree that in time of war or national emergency there is a need for a National Shipping Authority, or a wartime counterpart, with broad powers of control over ocean-going merchant ships. Such agency, operating under the national policy promulgated in Section 101 of the Merchant Marine Act of 1936, and under the guidance of the Director of Defense Mobilization, will insure that military drafts for merchant type ships are met to the maximum practicable extent, subject to being acquired, operated and controlled in conformity with the requirements and plans of the military authorities and the exigencies of the military situation.

c. In extension of the above the Department of Defense and the Department of Commerce agree it is essential that the Department of Defense have under its exclusive custody, jurisdiction and control, at all times, a nucleus fleet of size and composition to meet current conditions and military requirements.

d. The Military Sea Transportation Service, under the command of the Chief of Naval Operations, is the sole agency of the Department of Defense for providing all ocean-going transportation for the Department of Defense (excluding personnel and cargo transported by units of the fleet), and as authorized or directed for other Government agencies or departments of the United States, subject to priorities established by the Joint Chiefs of Staff. In the exercise of this responsibility the Commander, Military Sea Transportation Service, as directed by higher authority, must retain the power of decision concerning the suitability of arrangements and undertakings which affect vessels under his control.

3. Purpose:

a. To provide for the permanent or temporary transfer and/or allocation and utilization of merchant type ships between the Department of Commerce and the Department of Defense.

4. Ship requirements under conditions short of full mobilization:

a. Under conditions short of full mobilization there is required under the exclusive custody, jurisdiction, and control of the Department of Defense a nucleus fleet of ships assigned to the Military Sea Transportation Service. The size and composition of this fleet will depend on requirement considerations. Numbers and types of ships

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in the nucleus fleet will be kept adjusted in response to changes in the military situation as determined by the Department of Defense and specified to the Department of Commerce. The nucleus fleet shall comprise those transports, cargo ships, tankers, and specialized types of ships in sufficient number:

(1) To carry out current logistic needs of the military departments which cannot be met by commercial interests,

(2) to provide immediate capability in an emergency and,

(3) To provide an adequate base for necessary expansion to meet emergency or mobilization requirements in support of approved plans for national defense.

b. (1) Under present world conditions, based upon the considerations in paragraph 4(a) above, the nucleus fleet assigned to the Military Sea Transportation Service is expected to remain within close limits of the following by types:

(a) Transports:	56 Ships
(b) Dry Cargo:	28 Ships
(c) Reefer Cargo:	6 Ships
(d) Tankers:	61 Ships
(e) Specialized types:	
Aircraft Carriers	2 Ships
Misc. Small Craft	57 Ships
Total All Types -	210 Ships

(2) The numbers set forth above are subject to review and redetermination in accordance with military operation requirements. Limited changes in numbers can be effected by request of the Department of the Navy to the Maritime Administration. Substantive changes in numbers, types or tonnage will be approved by the Secretary of Defense and the Secretary of Commerce.

c. All merchant shipping capability required by the Department of Defense, in addition to that provided by the MSTS nucleus fleet, will be obtained, consistent with military requirements and prudent management, in the following order of priority:

(1) Maximum utilization of available U. S. flag berth space.

(2) Time or voyage charter of suitable privately-owned U. S. flag merchant ships to the extent these are voluntarily made available by the maritime industry. Such time or voyage charters will be kept to the minimum necessary to meet requirements which foresight indicates cannot be met by U. S. flag berth operators.

(3) Shipping provided by National Shipping Authority under General Agency Agreement or other arrangement, or

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(h) In the event suitable U.S. flag shipping is not available under the conditions stated above, the Military Sea Transportation Service may employ foreign flag shipping only to the extent necessary to meet urgent military requirements.

d. Ships of the MSTS operating nucleus fleet which are replaced or no longer required by MSTS will be placed in the National Defense reserve fleet for preservation and would be available to MSTS for use in an emergency.

5. Ship requirements under conditions of full mobilization:

a. The Department of Commerce will provide the additional merchant type ships required to be under the exclusive custody, jurisdiction, and control of the Department of Defense in meeting the requirements of the latter under conditions of full mobilization.

b. Under conditions of full mobilization the MSTS nucleus fleet will be augmented by those types and numbers of ships (in terms of notional merchant type ships) set forth in Annex "A", which, for security purposes, is made available to the parties of this agreement separately as a classified annex. Annex "A" is consonant with a memorandum approved by the Director of Defense Mobilization under date of June 4, 1954. As changes occur in the mobilization plans of the Joint Chiefs of Staff, appropriate revisions to Annex "A" will be made to reflect the altered military requirements. The specific hull types required under the exclusive custody, jurisdiction and control of the Department of Defense, and the desired phasing of their transfer will be as specified by the Chief of Naval Operations who may delegate such authority to the Coordinator of Shipbuilding, Conversion, and Repair.

c. Requirements of the Department of Defense for shipping in excess of that assigned to its exclusive jurisdiction and control will be submitted to the MSA and will be furnished in accordance with approved mobilization procedures.

d. During the period of full mobilization, the Department of Defense will continuously review the number of merchant type ships under its control. Any excess of such merchant ships will be made available to the Department of Commerce for other employment as appropriate, dependent on the projected duration of the excess.

e. At the time of termination of hostilities or in the event of a partial demobilization prior to the termination of hostilities, the MSTS fleet will be reduced correspondingly with the reduction in military requirements. In the event of such reduction MSTS ships not scheduled for retention as a part of the permanent operating forces of the Navy (either active or laid-up) will be released from Department of Defense control on the following priority basis:

(1) Ships under charter from private owners.

(2) Ships requisitioned from private owners.

(3) War-built merchant types desired for sale to U. S. citizens to restore privately-owned American merchant marine.

(4) Other types as may be mutually agreed.

x (4) Other types as may be mutually agreed.

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6. Naval Auxiliaries:

a. In addition to the above-required merchant type ships to meet ocean transportation requirements of the Department of Defense, the Department of Commerce, under conditions short of full mobilization and conditions of full mobilization, will transfer to the Department of the Navy the numbers and types of ships as are required for conversion to naval auxiliaries. The Chief of Naval Operations (Coordinator of Shipbuilding, Conversion, and Repair) will keep the Maritime Administration informed as to the specific ships required and the desired phasing of their transfers.

C E Wilson
For the Department of Defense

Louis Neel
For the Department of Commerce

16 August 1954

United States General Accounting Office

GAO Testimony

For Release
on Delivery
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November 17,
1987

Controversy Regarding the Ready Reserve Force

Statement of
Bill W. Thurman, Deputy Director for Planning and Reporting
National Security and International Affairs Division

Before the
Subcommittee on Legislation and National Security
Committee on Government Operations
House of Representatives

GAO/T-NSIAD-88-7

Mr. Chairman and members of the Subcommittee:

We are pleased to be here today to discuss certain policy and administrative matters concerning the Ready Reserve Force (RRF). At your request, we asked the involved agencies for their position on all these matters. Today, we are providing a document that outlines the positions of the Maritime Administration (MARAD), Military Sealift Command (MSC), and representatives of the maritime industry on various aspects of the RRF. My statement summarizes the information contained in this document.

The RRF is a quick response, government-owned merchant ship reserve fleet maintained by MARAD for use by the Navy in the event of a mobilization or national emergency to transport military cargo.

The Navy and MARAD disagree about important aspects of the RRF, and we are concerned about the potential adverse effect this disagreement may have on rapid sealift response capability and readiness.

The Merchant Ship Sales Act of 1946 authorized the creation and maintenance of a government-owned merchant ship reserve fleet. This fleet is called the National Defense Reserve Fleet (NDRF) and consists of ships laid up in a preservation status. It provides supplemental shipping capacity that the United States can rely on during a military or commercial shipping crisis.

In 1976, the RRF was formed by a Memorandum of Agreement (MOA) between the Navy and MARAD in recognition that the NDRF could not be activated in time to meet emergency military sealift requirements. As of October 1987, the RRF consisted of 86 ships maintained in a 5- to 20-day readiness status. DOD plans call for 120 ships by fiscal year 1992.

From fiscal years 1977 to 1981, the Navy provided most of the funding for the operation and maintenance of the RRF. After fiscal year 1981, the Navy funded all operation and maintenance expenses. RRF ship acquisition costs were funded by MARAD from fiscal years 1977 to 1983 and by Navy thereafter. Navy operation and maintenance expenditures for the RRF amounted to $220.4 million for fiscal years 1977 through 1986, while MARAD spent $4.3 million for salaries and related expenses from fiscal years 1977 to 1981. The cost of acquiring RRF ships has totaled $469.5 million -- $321.2 million spent by the Navy since fiscal year 1984 and $148.3 million spent by MARAD prior to fiscal year 1984.

Authority and Responsibility for the RRF Program

MARAD and MSC disagree over which agency is responsible for the RRF. The dispute surfaced in 1985. It involves whether the RRF is a part of the NDRF, how the RRF ships may be used, who owns and controls them, and what type of contract should be used to acquire operation and maintenance services for the RRF.

Whether or not the RRF is part of the NDRF is a primary point in the interagency debate over authority and responsibility for the RRF program. MARAD states that the Merchant Ship Sales Act of 1946, which created the NDRF, is the only statutory authority for creating and maintaining a government-owned merchant ship reserve fleet. Therefore, MARAD believes the RRF is part of the NDRF. MARAD also notes that the 1976 and the revised 1982 Memorandums of Agreements between the Navy and MARAD recognize the RRF as an element of the NDRF.

MSC states the RRF was created through an interagency agreement and has no legislative foundation. The Navy proposes to change the 1982 MOA on the basis that the RRF ships are acquired for strategic sealift purposes and are now funded entirely by the Navy. In August 1987, the Navy submitted a revised MOA to MARAD. To date no agreement on this proposed revision has been reached.

Current and Proposed Contract Types for RRF Services

MSC and MARAD disagree over the best type of contract to maintain and operate the RRF. The MOAs between MARAD and the Navy specify that RRF ships will be manned and operated through General Agency Agreements (GAAs) between MARAD and individual shipping companies. This is a common contracting instrument used in the maritime industry and is a form of cost plus fixed fee contract. The contractor receives a fixed fee in addition to reimbursement for allowable costs. MARAD awarded its GAAs on a sole-source basis from among a closed group of general agents on the basis of

technical qualifications or previous ship ownership. MARAD has used GAAs for the NDRF since its establishment about 40 years ago. MARAD states that the legislation that created the NDRF allows MARAD to use GAAs.

In keeping with the current government procurement policy of greater competition, in 1985 MARAD undertook to change its previous sole-source award process. Subsequently, at the Navy's request, MARAD changed to an open, fully competitive, firm-fixed price Request for Proposal (RFP) contract award process. In November 1986, MARAD provided more than 430 copies of the RFP to industry. Twenty-seven proposals were received in response to the RFP and, after MARAD's evaluation, 17 remain in final competition. MARAD hopes to award contracts by November 23, 1987.

Although MARAD's RFP addresses the Navy's concerns about using a fully competitive process, it does not place as much responsibility on the contractors as the Navy thinks it should. The Navy wants the contractors to be financially accountable for nonperformance. The Navy contends that congressional authorization and appropriation acts provide it the authority to direct the expenditure of funds for the RRF. Accordingly, the Navy has asked MARAD to include a contract clause that reduces payments for nonperformance. This is called an "off-hire" clause. The Navy has also asked that clauses be included that require liquidated

damages and insurance. The Navy contends that without these elements, MARAD's RFP does not place enough responsibility on the contractors.

MSC has informed MARAD that no Navy funds can be used to award RRF operation and maintenance contracts until the issues associated with the RFP are resolved. If the Navy withholds funds for current general agency agreements, as well as contract awards under the RFP, the RRF program will be severely affected.

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Mr. Chairman, while we have not performed sufficient work to recommend specific courses of action on this matter, it seems clear that to avoid the possible degradation of our nation's quick response sealift capability the administration should act expeditiously to resolve this interagency dispute. Since the issues involve both defense policy and economic considerations, the administration should consult with the Congress in resolving this matter.

This concludes my prepared remarks and I would be pleased to respond to any questions.

POSITIONS OF THE MARITIME ADMINISTRATION, MILITARY SEALIFT COMMAND, AND MARITIME INDUSTRY REPRESENTATIVES REGARDING VARIOUS ASPECTS OF THE READY RESERVE FORCE

PREPARED BY THE U.S. GENERAL ACCOUNTING OFFICE

NOVEMBER 17, 1987

PREFACE

At the request of the Subcommittee on Legislation and National Security, House Committee on Government Operations, the staff of the General Accounting Office (GAO) gathered information on the positions and views of the Maritime Administration (MARAD) and the Navy's Military Sealift Command (MSC) concerning the acquisition, operation, and maintenance of the Ready Reserve Force (RRF). The Navy and MARAD disagree about important aspects of the RRF.

The purpose of this document is to summarize the information GAO obtained from the two agencies as well as the views of a number of representatives of the maritime industry. GAO did not independently verify the information presented, nor did it performed a legal analysis of the various aspects of the disagreements concerning the RRF.

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ABBREVIATIONS

DOD	Department of Defense
DOT	Department of Transportation
FFP	Firm Fixed Price
FSS	Fast Sealift Ship
GAA	General Agency Agreement
GAO	General Accounting Office
MARAD	Maritime Administration
MOA	Memorandum of Agreement
MSC	Military Sealift Command
NDRF	National Defense Reserve Fleet
O&M	Operation and Maintenance
RRF	Ready Reserve Force
RFP	Request for Proposal
SCN	Shipbuilding and Conversion

APPENDIX I

MISSION AND ADMINISTRATION OF RRF

This appendix provides information on the establishment, mission and overall administration of the Ready Reserve Force (RRF). RRF funding, contractor performance, and applicable procurement statutes regarding the use of General Agency Agreements (GAAs) are also discussed.

ESTABLISHMENT AND MISSION

The RRF was established in November 1976 through a Memorandum of Agreement (MOA) between the Assistant Secretary of the Navy and the Assistant Secretary of Commerce for Maritime Affairs. This agreement recognized that the National Defense Reserve Fleet (NDRF) could not be activated in time to meet emergency sealift requirements. Thus, the RRF was created to provide the country with the capability to conduct quick response sealift by requiring cargo ships to be activated within 5 to 10 days of notification. This response period was subsequently changed to within 5 to 20 days of notification.

The RRF is composed of a mix of ships selected and upgraded from the NDRF and other ships acquired by the Navy or the Maritime Administration (MARAD). Ships typically acquired for the RRF include break-bulk, Roll-on/Roll-off, and ships possessing the capability of loading and discharging cargo without benefit of shore-based cranes. As of October 1987, the RRF consisted of 86 ships. Current Department of Defense (DOD) planning calls for 120 ships by fiscal year 1992.

RRF ships are berthed at MARAD's three main reserve fleet locations: James River, Virginia; Beaumont, Texas; and Suisun Bay, California. In addition, many RRF ships are berthed at other locations in the continental United States, and in Hawaii and Japan.

The 1976 MOA specified MARAD's role in the management and operations of the RRF. A subsequent MOA, signed in October 1982, changed some aspects of MARAD's responsibilities. The 1982 MOA specified that MARAD would be responsible for acquiring, upgrading, and placing ships in the RRF; maintaining the ships in accordance with MARAD and Navy standards; activating and operating the ships periodically for readiness and operational tests; and planning the mobilization of the RRF.

The 1982 MOA also specified that the Navy, commencing in fiscal year 1984, would finance ship acquisition by MARAD. The Strategic Sealift Division under the Chief of Naval Operations was

responsible for providing these funds to MARAD. However, a subsequent Navy policy change in early 1986 transferred this responsibility to the Military Sealift Command (MSC).

The Navy proposes to change the 1982 MOA on the basis that RRF ships are acquired for strategic sealift purposes and are now funded entirely by the Navy. In August 1987, the Navy submitted a revised MOA to MARAD. To date no agreement on this proposed revision has been reached.

FUNDING FOR THE RRF

Since the inception of the RRF in fiscal year 1977, operation and maintenance (O&M) funds appropriated to DOD have been used to finance all upgrades, maintenance, and operation of RRF ships. Under the 1976 MOA, the Navy agreed to reimburse MARAD for direct costs and associated overhead costs related to establishing the RRF, including all ship preparation and repairs; performing annual tests; and activating, operating, and subsequently deactivating ships.

From fiscal years 1977 to 1981, the Navy provided most of the funding for the operation and maintenance of the RRF. After fiscal year 1981, the Navy funded all operation and maintenance expenses. RRF ship acquisition costs were funded by MARAD from fiscal years 1977 to 1983 and by Navy thereafter.

From 1977 to 1983, more modern ships were added to the RRF from commercial ships traded in to the U.S. government in exchange for construction differential subsidy[1] funding to build new ships and from Navy ships that had been removed from active service. Commercial appraisers identified the trade-in value of each commercial ship, and MARAD credited the value to the owners toward the cost of new ship construction. Under this subsidy program, 34 ships with a total value of over $139 million were traded in to the RRF. In addition, MARAD accepted seven ships from their commercial owners in exchange for their equivalent value in scrap. This exchange involved old and obsolete ships for which MARAD had no further use. The scrap value of these ships amounted to $9.3 million. From fiscal years 1977 to 1981, the Navy expended $42.8 million in O&M funds for RRF ships. During this period, MARAD expended $4.3 million in salaries and other expenses for the RRF.

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[1] Construction differential subsidy payments were intended to compensate the ship buyer for the additional expense of ordering a ship from a U.S. shipbuilder rather than from a foreign builder.

From fiscal years 1982 through 1986, the Office of the Chief of Naval Operations, Strategic Sealift Division, provided O&M funds to MARAD. In June 1986, the Navy identified MSC as the single manager for strategic sealift. As a result, beginning in fiscal year 1987, MSC replaced the Strategic Sealift Division as the funding sponsor for MARAD.

Beginning in fiscal year 1984, the Congress authorized and appropriated funds to the Navy for the acquisition of RRF ships. The appropriations are included in the shipbuilding and conversion, Navy (SCN) accounts. Prior to that time, MARAD paid RRF acquisition costs. The actual expenditures of SCN and Navy O&M funding from fiscal years 1982 through 1986 are shown in table I.1. Navy O&M expenditures include three major items: maintenance, activation/ deactivation, and upgrade. In fiscal year 1986, MARAD received RRF berthing funds from MSC as part of the overall O&M costs. MARAD, however, does not consider these berthing costs as part of O&M expenses because they are not viewed as ship maintenance.

Table I.1: Expenditures of SCN and O&M Funds by Fiscal Year

	1982	1983	1984	1985	1986	Total
			(millions)			
SCN (Ship acquisition)	$ -	$ -	$83.0	$31.0	$217.2	$321.2
O&M	12.2	14.7	29.9	53.1	67.7	177.6

ADEQUACY OF CONTRACTOR PERFORMANCE

According to MARAD, contractor performance has been excellent under GAAs. MARAD states that a number of actions contribute to successful activations, but the primary one is that the general agents and MARAD personnel work as a team to activate the ships.

From the inception of the RRF program to October 1, 1987, a total of 37 RRF ship activations, using 11 general agents, had been completed. Twenty-one of these activations were on a "no notice" basis and required successful activation within 5 or 10 days of notification.

According to MARAD, the only ship which failed to meet a activation deadline under a general agent agreement was the SS President by American President Lines and this was due to latent defects in the ship. Even though the SS President was classified as a 5-day RRF ship, it took American President Lines 71 days to complete the activation. MARAD attributed the failure to the ship's age and poor condition, citing severe deterioration between the time of its

first successful activation in July 1981 and the January 1985 attempt. Moreover, MARAD claimed it was short on maintenance and repair funds between these times because of the larger than expected number of RRF ships acquired.

During the activation, the SS President encountered boiler problems and its force draft fans failed. The ship was towed back to port, and the crane was found to be defective, even though it had passed inspection by American Bureau of Shipping inspectors. After repairs, the ship was successfully retested at sea, but MARAD decided to drop the SS President from the RRF.

On March 7, 1985, the Director of Strategic Sealift, Chief of Naval Operations, testified before the Subcommittee on Seapower and Force Projection, Senate Committee on Armed Services, that of the 10 ships activated since 1982, only 1 ship--the SS President--had failed.

MSC believes that the following four RRF ships also failed to be acceptably activated in the required time frame and should also be considered instances of contractor nonperformance:

--SS Washington. This 5-day RRF ship missed activation by 12 hours, 52 minutes on a "no-notice" activation to test its seaworthiness. Had the activation, which occurred in 1981, been for an exercise, the ship would not have been accepted due to problems with its cargo handling cranes, high salinity in the boilers, numerous leaks, and an operational restriction imposed by the U.S. Coast Guard.

--SS Lone Star Mariner. This 10-day RRF ship, which was activated in 1982, met the activation schedule but was not accepted because of patching on a tank top and deteriorated external electrical wiring. The ship was scrapped in November 1985.

--SS California. This 5-day RRF ship, which was activated in 1983, met the activation time, but operational control of the ship was not accepted for another 3 days due to expired U.S. Coast Guard certificates.

--SS Pioneer Crusader. This 10-day RRF ship missed a "no-notice" activation deadline by 3 hours. During the 1984 activation, the ship was tendered in 7 days but was not accepted due to incomplete repairs, tests, and an unsigned U.S. Coast Guard inspection certificate.

MANAGEMENT OF RRF SHIPS VERSUS MSC'S SHIPS

MARAD has managed RRF ships using GAAs. Under these agreements, general agents receive a fixed fee in addition to allowable costs incurred. All RRF ships are government owned. At the present time, 80 of the total 86 RRF ships are being maintained under agreements with 11 general agents. The Navy manages MSC ships using firm-fixed price contracts. Under these contracts, a firm-fixed price is agreed upon for operating and maintaining MSC ships with the contractors bearing the cost risks if a ship cannot perform. MSC would like MARAD to manage RRF ships in a manner more similar to MSC ships, many of which are privately owned. This disagreement is discussed in detail in appendix III.

APPLICABLE PROCUREMENT STATUTES ON USE OF GENERAL AGENCY AGREEMENTS

MARAD says its authority for use of GAAs in administration of the NDRF and the RRF subcomponent is found in section 207 of the Merchant Ship Sales Act of 1946, as amended (50 U.S.C., App. 1744). The act endorses the use of instruments available to private corporations and states that the contracting instrument to be used is determined by the Secretary of Transportation through MARAD. MARAD said that for about 40 years, GAA authority has appeared as formal, published regulations of MARAD and that such authority has never been questioned by DOD.

Neither MARAD nor MSC knows of any other government agencies that use GAAs.

Applicability of Competition in Contracting Act

MSC states that MARAD, in the past, has awarded GAAs on a sole-source basis without obtaining maximum practical competition as required by the Competition in Contracting Act of 1984. MARAD states that it is legally exempt from following this act by 40 U.S.C. 474(16). But, the Department of Transportation (DOT) and MARAD state that they recognize the wisdom of competition and pursue it to the maximum extent possible.

The Navy believes that MARAD has no statutory authority for the RRF. It states that the RRF was established through the 1977 DOD authorization and appropriation acts and that MARAD's authority and responsibility for the RRF are limited to those functions listed in the 1982 MOA. The Navy does not believe MARAD is exempt from the requirements of the Competition in Contracting Act when contracting for the RRF and the NDRF.

The Navy states that it is important for the government to ensure that the contractual instrument combines maximum readiness, contractor accountability, and cost effectiveness. The Navy contends the GAA insulates a contractor from all responsibility or liability for providing the Navy with the levels of readiness required by the agreement. According to the Navy, the use of firm-fixed price contracts awarded in accordance with the Federal Acquisition Regulation would place an "appropriate" level of responsibility for readiness on the contractor. This is the same manner in which the Navy has operated its fleet of about 130 commercial ships.

DISAGREEMENT OVER AUTHORITY FOR THE RRF

The Department of Transportation, acting through MARAD, and the Department of the Navy, acting through MSC, disagree about which agency has responsibility and authority for the RRF. The agencies disagree about whether the RRF is part of the NDRF, how a prepositioned crane ship can be used, and who owns newly acquired RRF ships.

MARAD'S POSITION REGARDING THE RRF

MARAD believes that it alone has authority to maintain the RRF and that, in exercising that authority and the concomitant authority to approve use of such ships to carry defense cargoes, it is subject to various congressional limitations on competition with commercial ocean carriers.

MARAD maintains that section 11 of the Merchant Ship Sales Act of 1946, as amended (50 U.S.C., App. 1744), is the only statutory authority supporting the creation and maintenance of a government-owned merchant ship reserve fleet (see app. V.). This fleet is designated the National Defense Reserve Fleet and all ships placed in it must be preserved for national defense purposes or the movement of commercial cargoes during times of national economic crisis. MARAD states that it is the sole agency responsible for balancing the commercial maritime interests and national defense maritime considerations. Thus, the NDRF has both a defense and a non-defense function, and the act vests responsibility for the administration of the single merchant reserve fleet in the Secretary of Transportation. MARAD further states that the dual purposes of the NDRF have been repeatedly recognized by various authorities, including DOD and the Congress.

The RRF was created through a MOA between the Navy and MARAD in 1976 in recognition of a "mutual" interest and responsibility in the joint establishment, maintenance, and control of an RRF as an element of the NDRF maintained by MARAD. MARAD stated that at no point, before or after the establishment of the RRF, was the fact that the RRF was an integral part of the NDRF discussed, much less challenged. It is MARAD's position that this also was the understanding of the Congress because various committee reports describe the RRF as a "subset" or "component" of the NDRF. It believes this is true whether funds for the RRF are appropriated to MARAD or the Navy.

During congressional hearings before MARAD's fiscal year 1987 authorization, possible amendments to the law (section 11 of the 1946 act) were explored to specify that the RRF was part of the NDRF. MARAD maintained that this was an unnecessary change because it was responsible for the NDRF under existing law and that the RRF

was a subunit of the NDRF. A "Statement of Administration Policy" from the White House to the Congress advised that this amendment was unnecessary. Consequently, section 11 was not amended.

MSC believes that its statutory authority to administer the RRF is based on the Navy having received appropriations to purchase merchant ships for a reserve fleet and that an appropriation implied an authorization for MSC to administer the ships purchased. MARAD states that, as a general matter, it does not dispute the fact that an appropriation implies an authorization, but that the appropriation and authorization language must be reviewed to determined what was intended. Consequently, the DOT Office of General Counsel examined the DOD appropriations and authorization acts for fiscal years 1984, 1985, and 1986. These years were selected because they followed the 1982 revision to the MOA in which the RRF is clearly identified as a part of the NDRF.

In these acts, the only applicable reference DOT found was to the "strategic sealift program" (the DOD program name for the RRF), without explanation. In the absence of specific language in these appropriations and authorization acts, MARAD believes that the program was approved and understood by the Congress to be managed by MARAD. According to MARAD, the 1982 MOA was a "contemporaneous expression" of the program of which the Congress was aware. When the fiscal year 1984, 1985, and 1986 appropriations and authorization acts were enacted, the MOA clearly characterized the RRF as part of the NDRF. Thus, MARAD maintains that DOD has no authority to maintain a fleet of reserve merchant ships.

MSC'S POSITION REGARDING THE RRF

MSC states that acquisition and conversion of merchant ships for the RRF have been funded by the Navy as authorized by the Congress through the DOD appropriations acts. Specific funding for acquisition of ships for the RRF is provided by the Congress in the Navy's shipbuilding and conversion appropriation. Additionally, the Navy finances the operation and maintenance of the RRF with its O&M appropriations. MSC states that inherent in the appropriation of funds to any executive agency is the accountability of that agency for the proper expenditure of those funds. Therefore, since the Congress has authorized Navy funding for the acquisition, operation, and maintenance of RRF ships, MSC argues it must have "plenary authority" to make decisions necessary to achieve the most efficient expenditure of that funding, which now exceeds $200 million per year. MSC maintains that a program of such magnitude demands that the Navy appropriately allocate risk and cost management.

MSC believes that the term Ready Reserve Force was initially meant to distinguish RRF ships from NDRF ships. It is MSC's position that the RRF was never intended to be a functional element of the NDRF. MSC states that these two groups of ships are funded separately, operated separately, and were established for separate purposes.

MSC maintains there is no statutory basis for the RRF and the RRF exists because DOD decided to allocate a portion of its annual O&M and SCN appropriations to acquire and maintain ships for the RRF. In contrast, the NDRF has roles in national defense and non-defense (economic) crises. MSC concludes that it needs general authority to manage the RRF since this force was established specifically to satisfy military strategic sealift requirements and is dedicated solely to national defense. MSC supports its position by noting that the Congress, in legislation affecting DOT, has recognized that the Navy has the authority to make decisions affecting the acquisition of ships for the RRF, as distinguished from the NDRF.[1]

Additionally, MSC maintains that it can purchase, and it has, ships for strategic sealift using Navy contracting officers and that it can execute Navy contracts to operate and maintain these ships. MSC states that it is illogical to conclude that the Navy surrenders jurisdiction over the RRF every time MARAD contracts for maintaining the RRF since the Navy could retain this function by using its own administrative capability.

MSC further states that MARAD contends that the RRF should be part of the NDRF because it "will continue the civilian control of merchant shipping required to satisfy the priorities involving military operations and general economic support of the private sector under both normal and contingency situations." MSC believes this position is contrary to the uniquely military purpose of the RRF and its Navy funding, as well as to the 1976 and 1982 MOAs that place primary decisionmaking authority for the RRF with the Navy. MSC cites the Merchant Ship Sales Act of 1946 as another reason why NDRF ships cannot be used for any purpose whatsoever, except during a period when ships can be requisitioned under title 46, section 1242 of the United States Code. This section requires (1) a Presidential proclamation that the security of the national defense makes it advisable or (2) a national emergency declared by the

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[1] See Miscellaneous Changes to Laws Affecting the Coast Guard, Section 13, Public Law 99-307, enacted May 19, 1986; 100 Stat. 448. This law provides that before certain vessels may be sold to a foreign purchaser, the Secretary of the Navy may acquire the vessels for the RRF or the Secretary of Transportation may acquire the vessels for the NDRF.

President. Since a Presidential proclamation is not in effect, MSC states that "there is no authority within the Merchant Ship Sales Act of 1946 itself" to withdraw ships from the NDRF. Thus, MSC believes if the RRF is viewed as a part of the NDRF, it cannot use the ships for strategic sealift contingencies without a national emergency or Presidential proclamation. MSC believes this is counter to a fundamental reason that led to establishing the RRF in 1976, that is, to meet military requirements for a rapid sealift capacity that the NDRF and U.S. merchant fleet could not meet. MSC states that in 1976 the national emergency proclaimed by President Truman on December 19, 1950, was still in effect, so ships could be freely withdrawn from the NDRF. This state of national emergency was terminated by law in September 1978. For reasons that MSC states are not clear, the 1982 MOA did not contain any provision reflecting this change in law.

USE OF AN RRF CRANE SHIP

The Navy has requested that MARAD permanently transfer a specialized crane ship--the SS Grand Canyon State--from the RRF to MSC's active fleet and preposition it in the Indian Ocean with a field medical facility aboard. MARAD strongly objects to this proposal.

MARAD's position is directly linked to its belief that RRF ships are not Navy owned and their use is governed by statutory authority given to MARAD. MARAD believes that these ships may be activated for exercises to determine if readiness requirements can be met and that it cannot support call-ups made for purposes other than ship testing or supporting naval exercises.

MARAD does not question the strategic soundness of prepositioning a crane ship in the Indian Ocean area, but believes the storage of medical equipment aboard the ship is a modification of its special capability. In addition, medical equipment has been stored on a commercially chartered U.S. flag ship in that area and this action would compete with or replace such commercial ships. Furthermore, MSC notified MARAD that it is considering the use of a civil service crew to operate the ship. MARAD believes that this proposal would break a very effective contract with a commercial firm to train crane operators and maintain, activate, and operate the ship.

The Navy maintains that it owns the Grand Canyon State and thus the ship can be used for what it considers an appropriate mission. It also contends that this ship has a unique cargo lifting capability needed to satisfy a military requirement. Furthermore, the Navy believes that the prepositioning of hospital equipment aboard this ship is a prudent use of an otherwise empty ship and sees no

difference between this type of storage and ashore storage. The Navy also believes a civil service crew should be used if that is the most cost-effective method.

NAVY'S PROPOSED CHANGES TO SHIP DOCUMENTS FOR NEWLY ACQUIRED SHIPS

During fiscal year 1987, the Navy terminated the yearly transfer of RRF ship acquisition funds (SCN) from the Strategic Sealift Division of the Chief of Naval Operations to MARAD. Under a new procedure, MSC purchases ships for the RRF directly from their commercial owners. MARAD objects to this procedure and states it is "concerned that such action is inconsistent with the Administration's policies and the testimony and submissions to the Congress."

In addition, the Navy has advised DOT of its intention to place nine newly acquired ships in its own fleet of reserve commercial ships by adding them, as public vessels, to a laid-up segment of the MSC fleet.

DOT's position on these ships is expressed in a memorandum dated August 28, 1987, from the Deputy Secretary of Transportation to the Commandant of the United States Coast Guard. In part, it states that DOT has repeatedly asked the Navy for an explanation of its legal authority to maintain its own fleet of reserve commercial ships. However, despite assurances that such an opinion would be provided, DOT never received one. Further, DOT's Office of General Counsel examined the issue and found no such authority. On these bases, DOT concluded the Navy does not have the authority to maintain a fleet of reserve commercial ships and does not have authority as purported owner of such ships. This memorandum requests that no action be taken or agreed to by the U.S. Coast Guard with MSC that would allow the ships being acquired for the RRF to be documented in any manner that differs from past practice. DOT stated that, over the past 10 years, RRF ships have been documented with the U.S. Coast Guard as being owned by the United States as represented by the Secretary of Transportation acting by and through the Maritime Administrator.

MSC and the Assistant Secretary of the Navy (Shipbuilding and Logistics) believe that the RRF is not a jurisdictional element of the NDRF and that the Navy, acting through MSC, should be the owner of record of RRF ships acquired with Navy funds. It is also the Navy's position that the RRF was established in DOD's 1977 authorization and appropriation acts solely to provide rapidly available strategic military sealift in crises, contingencies, or during full mobilization. MSC believes that as the single manager for strategic sealift it should manage this force separately and distinctly from the NDRF.

The Navy also believes that the provisions of the Merchant Ship Sales Act of 1946 have no applicability to the purchase of ships for the RRF from funds specifically appropriated to DOD for this use. It believes that the act deals with ships "owned" by DOT and that since DOD buys the ships, they are owned by DOD, not DOT. Also, the Navy maintains that ships will acquire "public vessel" status by virtue of being owned and operated by the government and thus their status would be the same, regardless of whether MARAD or MSC is reflected as the owner in the ships' documents.

APPENDIX III

DISAGREEMENT OVER TYPE OF CONTRACT FOR THE OPERATION AND MAINTENANCE OF THE RRF

During the past few years, MARAD and MSC have disagreed on the overall administration of the RRF. The Navy is particularly concerned about MARAD's use of GAAs to obtain RRF operation and maintenance services. Aside from the issues of competition and cost versus firm-fixed price contracts, the Navy asserts that MARAD lacks sufficient controls over contractor costs and that the government is not adequately protected against nonperformance by a contractor.

MARAD believes these assertions are inaccurate and additional costs are associated with MSC's approach for acquiring these services. Nonetheless, it attempted to address the Navy's concerns by changing from a GAA to a firm-fixed price type contract with certain costs on a reimbursable basis. The RFP for such a contract, however, did not fully incorporate the Navy's preferences on the issues of contractual relationship, off-hire (reduction in payment for periods of nonperformance), insurance, and liquidated damages; and the Navy objected to it.

TYPE OF CONTRACTS ADVOCATED

MSC and MARAD disagree on the type of contract to acquire services for the operation and maintenance of RRF ships. MARAD, which believes it has been given authority by statute to determine the contract type, uses GAAs with shipping companies to obtain such services. Its use of GAAs was not questioned until 1985. MARAD believes this practice, which is commonly used in the maritime industry, is the most expedient and cost-effective method of contracting for these type services. On the other hand, MSC contends that it has the authority, through congressional authorization and appropriations acts, to direct the "proper and effective" expenditure of funds for the RRF. It believes that firm-fixed price operating contracts would be more cost effective than GAAs if increased readiness is considered.

MARAD'S AWARD OF GAAS

In the past, MARAD's GAAs were awarded on sole-source basis with the awardee selected from a closed group of general agents on the basis of technical qualifications or previous ship ownership. Under the general agent concept, a contractor receives a fixed fee in addition to the actual costs it incurs. According to MARAD, the contract is controlled by the government and funds are only expended for the work authorized by the government. The agreements are effective until terminated, upon 30 days notice, by either the

general agent or the government. Currently, 80 of the 86 RRF ships are being maintained under agreements with 11 general agents. According to MARAD, the six ships without agents are small break-bulk ships that the Navy plans to downgrade and place in the NDRF.

GAA rates

In 1977, when GAAs were initiated for RRF ships, the agent received an annual retainer fee of $6,000 a ship. That amount was basically the profit realized by the general agent for acting on behalf of the government in providing operation and maintenance services for RRF ships. Under the agreement, the agent also received out-of-pocket expenses, lodging, travel, salaries, fringe benefits, etc; for personnel operating and maintaining the ships, plus a daily administrative expense of $35 for each person assigned to the ship. Upon turning a ship over to the general agent for activation or operation, the agent received a daily management fee of $200, plus out-of-pocket expenses for persons directly involved with the ship's activation.

However, in 1984, with bids on the Keystone State (a unique multi-crane ship), three T-1 tankers, and the Southern Cross (a break-bulk ship), agents began seeking higher amounts for daily costs. Currently, the standard rates are $125 a day for laid-up ships and $300 a day for active ships. These rates, however, may vary because of unique ship characteristics. For example, the daily rates to manage three tankers located in Hawaii and Japan are $120 for laid-up ships and $160 for active ships, while the laid-up and active rates for the Keystone State are $175 and $390, respectively.

For fiscal years 1976 through 1987, MARAD provided $245.8 million to general agents. Of this amount, $6.4 million was for retention fees and $239.4 million was for operation and maintenance services. During this period, services were provided for an RRF force level that ranged from 16 to 76 ships.

Review of agent's cost submissions

MARAD officials cited specific procedures they use to review an agent's cost submissions and to safeguard against agent cost abuse. Funds are monitored closely by MARAD and withdrawals involving payments directly to the agent require the signature of both the agent and a MARAD contracting official. Also, a contracting officer's technical representative is assigned to monitor performance under the GAA. According to MARAD, general agents request an advance of funds monthly and provide an explanation of their proposed uses. MARAD reviews the request and grants approval if it coincides with the maintenance plan for the ship. At the end

of the month, the general agent submits cost reports for all funds expended, which MARAD reviews for deviations from the forecast and for the proper assignment of funds.

The DOT Office of the Inspector General periodically audits the accounts of general agents. These audits normally occur after a major project such as an activation or deactivation. If a cost is found to be excessive or otherwise not allowable, it is disallowed or adjusted. If excess funds have been advanced, the general agent returns the funds to MARAD. Recent Inspector General audit reports on general agent cost submissions show that, in most instances, any cost adjustments recommended were accepted and the agent reimbursed the government. Reports concerning 11 general agents and various audit periods between May 1985 and March 1987 show individual audit report adjustments ranging from zero to about $245,000. The total actual disallowances were about $482,000, and about $290,000 has been recovered. According to MARAD, the remaining $192,000 either has been supported by the agent or is pending a review by MARAD officials.

According to MARAD, under the current RFP for a firm-fixed price contract (with certain portions reimbursable), the review procedures would change. The fixed-price portion would only be paid after MARAD verified completion of work and the payment could not exceed the negotiated fixed price. For reimbursable payments, MARAD would require advanced approval of orders. Reimbursable items would include such things as the acquisition and transportation of repair parts, testing of hydraulic and lube oil systems, and maintenance briefings. In addition, MARAD would verify all invoices for reimbursable items and receipt of all reimbursements.

NAVY'S OBJECTIONS TO THE GAA TYPE CONTRACT

In objecting to GAAs, the Navy raised the issues of inappropriate pricing and business arrangements and MARAD's inability to enforce contractor performance and accountability. The Navy states that the operation and maintenance of RRF ships are not complicated and that the minimum needs can be described in a carefully developed performance of work statement. Consequently, the Navy believes that the appropriate contract type is a firm-fixed price contract under which the contractor has full responsibility for completing the contract at the agreed upon fixed price. The Navy uses firm-fixed price contracts for the operation and maintenance of its cargo ships, which are similar to those in the RRF.

The Navy further contends that under the GAA, the general agent is rarely held accountable for his actions and is not held liable when performance is not carried out. In contrast, the Navy states a

firm-fixed price contract links performance to price and the contract price is reduced whenever a contractor fails to perform in accordance with the contract performance work statement.

MARAD states that the Navy's comments concerning the GAA form are based on a misunderstanding of the agreement used for the RRF. The traditional GAA, which is published in title 46, part 315 of the Code of Federal Regulations, is used for other NDRF ships, while a new GAA, which was devised for the RRF in 1977, is used for all RRF ships. MARAD states that the new GAA carefully defines allowable and nonallowable costs and allows for termination at any point with no additional cost. MARAD believes this approach is more beneficial to the government than the normal process of terminating for default or convenience.

The GAAs used for the RRF retain the liability and indemnity clauses that limit the contractor's monetary liability. MARAD states it is not realistic to impose insurance requirements in wartime or emergency situations because it would merely add costs that the agent-contractor would pass on to the government. It contends that the standard of willful or gross negligence and the contractor's monetary liability ceiling of $500,000 in the RRF agreement recognize that the application of normal, peacetime standards of operations in crisis operations is not viable.

MARAD BELIEVES RRF OPERATING COSTS WILL INCREASE

MARAD contends that using a contractor versus a general agent will increase contract costs from about $100 million to $187 million over the 5-year contract period for 75 ships. According to MARAD, under the firm-fixed price contract approach, it will also incur additional administrative costs related to:

--Increased contract administration staff. An additional two or three employees would be needed to process an additional 1,000 modifications or work orders.

--Reduced flexibility. MARAD cannot increase or decrease work contracted for, due to budgetary reductions or increases, without incurring administrative costs related to contract termination for convenience or prolonged negotiations.

--Increased requests for work approval. Contractors will demand that MARAD fund and approve all maintenance work requested or will advise that they are not responsible for timely activations.

MSC officials stated that they expect contract costs to increase during the transition from GAAs to firm-fixed price contracts. They do not, however, believe the increased costs will be excessive but are willing to pay for the assurance of readiness.

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MARAD'S RFP AND MSC'S REACTIONS

MARAD responded to the Navy's concerns by revising its solicitation for general agents from a sole-source, cost plus fixed-fee approach--the GAA--to a fully competitive firm-fixed price RFP. The RFP initially covers the operation and maintenance of 70 RRF ships which are divided into 16 groups. These groups were established on the basis of geographic dispersion and commonality of ship design type. Although a firm may bid on all of the groups, a firm cannot receive a contract for more than two groups. In addition, MARAD established an Office of Acquisition staffed with personnel knowledgeable about DOD's contracting procurement policy to improve RRF administration. According to MARAD officials, they and MSC differed on 16 issues concerning the RFP. MARAD incorporated MSC's recommendations on 12 of these issues. The remaining four unresolved areas are:

Contractual relationship - MARAD's RFP provides for a ship manager that is responsible for the overall management of the RRF ship. Except in the operational phase of the RRF program, the ship manager's accountability for performance is judged on a case by case basis. MSC believes this type of contractual relationship places an insufficient amount of liability upon the ship manager to fulfill the contract. MSC believes the RFP should require contractors to be held financially accountable for nonperformance in all phases of the RRF program.

"Off-hire" clause - This clause provides for the reduction of payments under the contract by a specific amount for each day a ship does not fully meet operational requirements. MARAD's RFP institutes this during the operational phase, but MSC wants this clause to be effective throughout the contract.

Insurance - MARAD believes that a contractor's liability during a wartime or national emergency situation should not be more than the normal $500,000 for gross negligence. Therefore, under MARAD's RFP the government is self-insured. MSC would prefer that the contractor obtain liability insurance.

Liquidated Damages - Under MARAD's RFP there are no provisions for liquidated damages. MSC wants the contractor to pay the government $10,000 a day if the ship is not fully operational by the fourth day of notification.

The commander of MSC contends that the MARAD RFP still closely resembles general agency agreements and has prohibited MARAD from using Navy funds for the operation of the RRF by GAAs issued after November 20, 1986. MARAD is continuing to operate and maintain the RRF under existing GAAs.

RFP status

Without the concurrence of MSC, MARAD issued the RFP to 434 firms. Of these, 27 submitted proposals. After MARAD's initial evaluations, 17 proposals remained in the final competition. Best and final bid offers were received on October 15, 1987, and MARAD expects to award contracts before the November 23, 1987, expiration date of the offers. However, contract awards are contingent upon Navy or other sources of funding.

MARAD contends that the RRF program would be severely affected if the Navy withholds funds for contract awards under the RFP as well as current general agents. Without a contingency plan for manning and outfitting the RRF ships, the activation time period requirements will not be met. MARAD would need to obtain additional appropriations to retain the current agents and maintain the ships in a state of readiness. In addition, MARAD believes it may be subject to bid and proposal preparation cost claims totaling about $6.8 million from those firms remaining in the competition.

According to a MARAD contracting official, if a contract is not awarded by November 23, 1987, MARAD will have to continue using temporary GAAs and request an extension on the offers provided by offerors. This official believes that industry may deny the extension of time in an effort to force resolution of the four RFP contracting issues between MARAD and MSC.

APPENDIX IV

INDUSTRY'S VIEWS ON CONTRACTS ADVOCATED BY MARAD AND MSC

Some maritime industry officials believe the MSC contracting approach places too much risk on the contractor and, as a result, it will be more expensive, eliminate many highly qualified contractors, and encourage marginal contractors, who may not be able to perform in national emergencies, to submit proposals. Three items of particular concern are the issues of "off-hire" liability, insurance liability, and liquidated damages.

An industry official provided us a comparison of how matters related to these risk issues are treated in the MARAD/RFP and an MSC contract for a fast sealift ship (FSS). (See table IV.1 for the comparison). According to this official, the current RFP clauses shown in table IV.1 except for "off-hire" liability during operations (Phase O) are generally acceptable but the contract provisions proposed by MSC are not.

Table IV.1: Comparison of treatment of risk issues for selected contract types

MARAD General Agent	MARAD Ship Manager (Current RFP)	MSC Contractor (FSS contract)
OFF-HIRE	OFF-HIRE	OFF-HIRE
No liability	All Phases except Phase O[1], are judged on a case basis. Remedies may include: -Performance by ship manager for his own account. -Performance by Government and charged to the ship manager. -Reduction of per diem. -Termination for default. In Phase O, contract price is reduced by number of total days lost multiplied by the appropriate per diem.	Contract price reduction by amount equal to the total number of days lost multiplied by the appropriate per diem rate.
P&I INSURANCE	P&I INSURANCE	P&I INSURANCE
Government self-insured; no deductibles. Only actual expenses passed through.	Government self-insured, no deductibles. Only actual expenses passed through.	Contractor obtains $10,000,000/ incident coverage with $25,000 deductible per incident. Per diem charge to government reflects premium and an estimated number of deductibles whether used or not.
LIQUIDATED DAMAGES	LIQUIDATED DAMAGES	LIQUIDATED DAMAGES
No liability.	No liability.	$10,000/day paid to U.S. Government if the vessel does not reach full operating status by 4th day after notification to proceed.

[1] The RRF program has the following phases: Phase I - Acquisition; Phase II - upgrade; Phase III - Deactivation; Phase IV - Maintenance; Phase V - Exercise; Phase VI, Sealift Enhancement Features; and Phase O - operation;

Another industry executive provided the following comments and examples of how these issues could adversely affect a contractor.

"The risk/reward ratio of the Contractor is dramatically and adversely altered from that of a commercial contract or a MARAD GAA, when he takes on a Navy contract. The Contractor's profit is perhaps $50,000 a year per vessel in lay-up. In rare instances the vessel may be called up on short notice for service with the Military Sealift Command to operate for about three months. Under the Navy contract, for a mere additional profit perhaps of $25,000, in round numbers, the Contractor risks the possible loss of hundreds of thousands of dollars per vessel in penalties of one kind or another. For example:

(a) "Off-Hire Liability. If the vessel is placed in an "off-hire" status by the Navy, the Contractor receives no compensation for the days off-hire. The compensation lost is not just the Contractor's overhead, general administrative expenses, which are ongoing, and profit of perhaps $300 per day, but all daily contracted operating costs, which could run in full operational status to as much as $10,000 per day. Off-hire insurance can be obtained, and added to the bid price to the Government, but it does not start to pay out until after the vessel has been off-hire for fourteen days, creating an unavoidable exposure for the Contractor of up to $140,000...."

(b) "Liquidated Damages. When a laid-up vessel is ordered into service by the Navy and is not delivered for service (Full Operating Status "FOS") by the Contractor within the specified period of time (can be as few as four days), and the delay is caused or contributed to by the failure to properly perform or supervise the maintenance and repairs for which the Contractor is responsible, the Contractor then must pay a totally unrealistic and burdensome penalty of $10,000 per day or part thereof for all the time lost until the vessel is available for the Navy's service. This is in addition to the off-hire liability as described above."

(c) "Insurance Liability. Under a General Agency Agreement the Contractor is protected from lawsuits except for gross misconduct or willful negligence, but under the Navy contract he must hold the Government harmless from any liabilities, meaning unlimited exposure; so he must get insurance. The cost of this insurance from $100,000 annually in lay-up to $290,000 in operational status, plus the deductible cost for the

number of accidents that the Contractor guesses he will suffer, is included in the bid price to the Government; the more accidents the Contractor covers, the higher his bid and the lower his chance is to be low bidder. Suppose the Contractor has estimated three accidents per year, and the deductible is $25,000 per accident. Then an inspected and properly tested cargo crane cable parts and snakes across the deck, killing or injuring ten men. The Contractor is immediately liable for a $175,000 payment to cover the extra seven accidents. There are many other types of ruinous accidents which really cannot be controlled by the Contractor."

MARAD also received correspondence from a number of general agents declining to submit proposals in response to the RFP and from others voicing objections because of the impending risk clauses. The following are excerpts from some of this correspondence.

--Respondent A (Current General Agent for 16 RRF Vessels)

"After considerable deliberation and discussion, Respondent A has decided not to respond to the General Agency Agreement solicitation.

The terms/conditions of this solicitation place an unreasonable liability on the General Agent, and such an exposure is too great for us to provide a fixed price offer."

--Respondent B

1. "All risks of private ownership have been placed upon the managers shoulders with none of the benefits of private ownership."

2. "The risk to be assumed by the manager are of such vast proportions it precludes any attempts to reasonable account for them in our offered fee structure."

--Respondent C

"Respondent has decided not to respond to the above for the following reasons:

1. The unprecedented transfer of traditional ship owners risk to the ship manager by MARAD/MSC.

2. The untested legal ramifications and unknown financial impact which will flow from this reversal of roles.

3. Lack of the normal judicial processes to defend against MARAD/MSC who are at once, Judge, Jury and Prosecutor, blessed with unlimited financial resources."

--Respondent D (Current general agent for 13 RRF vessels)

"The off-hire penalty in our view is set too high, and the only way a manager will be able to cover himself will be to put in a high off-hire number for the operational phase. If the vessel succeeds in sailing without any off-hire during this phase of operation, the government has paid a high cost for protection which could have been obtained otherwise."

--Respondent E

"Quite frankly, we feel that the imposing of "Off-Hire" is not in the best interest to this contract and is certainly not cost efficient. It is clearly a departure from the proven and successful practice adhered to by the General Agents in their current contracts.

The imposing of an "Off-Hire" clause is unreasonable and any good manager under these circumstances will either not participate in this program or at least protect himself by increasing his fee and taking out insurance. If available, such insurance will be expensive...."

SECTION 11 OF THE MERCHANT SHIP SALES ACT OF 1946, AS AMENDED

(50 U.S.C. 1744)

(a) The Secretary of Transportation shall place in a national defense reserve (1) such vessels owned by the Department of Transportation as, after consultation with the Secretary of the Army and the Secretary of the Navy, he deems should be retained for the national defense, and (2) all vessels owned by the Department of Transportation on June 30, 1960, for the sale of which a contract has not been made by that time, except those determined by the Secretary of Transportation to be of insufficient value for commercial and national defense purposes to warrant their maintenance and preservation, and except those vessels, the contracts for the construction of which are made after September 2, 1945, under the provisions of the Merchant Marine Act, 1936, as amended [46 U.S.C.A. § 1101 et seq.]. A vessel under charter on June 30, 1960, shall not be placed in the reserve until the termination of such charter. Unless otherwise provided for by law, all vessels placed in such reserve shall be preserved and maintained by the Secretary of Transportation for the purpose of national defense. A vessel placed in such reserve shall in no case be used for any purpose whatsoever except that any such vessel may be used for account of any agency or department of the United States during any period in which vessels may be requisitioned under section 902 of the Merchant Marine Act, 1936, as amended [section 1242 of Title 46], and that any such vessel may be used under a bareboat charter entered into pursuant to authority vested in the Secretary of Transportation on July 1, 1950, or granted to the Secretary of Transportation after such date.

(b) Any war-built vessel may be made available by the Secretary of Transportation to any State maintaining a marine school or nautical branch in accordance with the Act of July 29, 1941 (Public Law 191, Seventy-seventh Congress; 55 Stat. 607 [sections 1123a–1123e of Title 34]).

(394226)

GAO/NSIAD-89-11FS (November 1988)

GAO
United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-226840

November 1, 1988

The Honorable Walter B. Jones
Chairman, Subcommittee on Merchant Marine
Committee on Merchant Marine and Fisheries
House of Representatives

Dear Mr. Chairman:

As part of our work in response to your request for a review of the policies and procedures of the Military Sealift Command (MSC), your Office requested that we obtain information on allegations that were made in a February 9, 1988, letter to the House Committee on Government Operations and that were referred to your Committee. As agreed with your Office, our work focused on allegations of crew shortages and improper travel charges. Although other allegations were cited in this letter, we addressed only these two because the others were outside the scope of our ongoing MSC review.

To assess the merits of the allegations, we obtained contractor and MSC correspondence, contracts, and other relevant records. We also talked with both MSC and contractor officials.

This fact sheet summarizes information provided to your staff on September 14, 1988.

BACKGROUND

One of the missions of MSC is to provide and operate ships for specialized military purposes, such as oceanographic ships to support the Navy's deep ocean survey program. MSC contracted with LSC Marine, Inc. to operate 12 oceanographic ships for 3 years. These operations began on May 21, 1986. LSC currently operates 11 of these ships; 1 ship had an accident and was withdrawn from service.

The allegations you referred to us were made by a former crew member on an oceanographic ship--the USNS Harkness. The two allegations we investigated charged that (1) the number of crew members and certain crew specialties required by the contract were not provided on the Harkness and (2) the contractor misused a Government Travel Request.

CREW SHORTAGES

Although this allegation has some factual basis, crew shortages were for valid reasons such as unexpected resignations or failure to secure required clearances. Also, according to MSC, the oceanographic ships may still operate effectively with crew shortages. MSC resolved this issue by accepting an LSC plan to minimize future crew shortages.

Our comparison of the alleged under-crewing for the USNS Harkness with MSC's crewing requirements for the ship disclosed that two alleged crew specialties, deck engine mechanics and machinists, were not required by MSC; in addition, MSC required only one electrician on board the ship versus the three electricians mentioned in the allegation. The total crew required by MSC aboard this ship is 50 crew members. Our comparison of this total for the Harkness with the actual numbers of crewmen sailing disclosed that from March to November '987 crew shortages amounted to 112 crew days--or less than 1 percent of the 11,750 total crew days required during this period. These shortages were mainly for steward assistants, able seamen, and bosuns; no electrician shortages were noted.

We reviewed deductions made by MSC from payments due LSC for not providing the required Harkness crew members and for the 10 other oceanographic ships during the period. Our review disclosed deductions of $21,593 for the 112 crew day shortages for the Harkness and $146,158 for shortages of 1,025 crew days for the other ships, each of which also experienced crew shortages.

LSC contested MSC's deductions, and on November 25, 1987, submitted a formal crew replacement plan. The plan identifies specific procedures for replacing crew members in a timely manner, thus minimizing future crew shortages. Among these procedures are the use of (1) emergency lists of union personnel available for assignment on short notice when normal dispatch procedures cannot be followed and (2) 24-hour telephone numbers to contact key union dispatch personnel.

The plan also recognizes that valid and unavoidable reasons for crew shortages sometimes exist, such as crew injury, illness, personal emergency, or desertion, and presents a formal way to minimize these shortages. Furthermore, the plan assigns the master of each ship the sole responsibility for assuring that total crewing is adequate for safe ship operations.

MSC concurred with LSC's plan and agreed that the oceanographic ships can be operated safely and effectively with fewer than the total number of crew members required by the contract. MSC believes that LSC's plan will minimize future crew shortages and does not intend to make routine contract deductions for crew shortages as long as LSC adheres to the plan. As a result, for the period we reviewed, MSC reinstated $105,386 of the $167,751 it had withheld because of crew shortages for the 11 oceanographic ships.

TRAVEL PRACTICES

The crew member also alleged that LSC had misused a Government Travel Request because he was required to pay $1,000 for his air fare to the United States. But, according to terms of the employment contract he signed, the crew member was not entitled to a transportation allowance because he had resigned by "mutual consent."

We obtained a copy of the crew member's contract which provided for a "...transportation allowance of $2.50 for each day of shipboard employment." However, the contract also provided that crew "...who depart by mutual consent prior to completion of assignment shall not be entitled to any amount accrued during such assignment." Moreover, the contract stated that LSC would have no obligation for any other transportation costs.

LSC officials told us the crew member resigned by mutual consent while the ship was in Djibouti, Djibouti. Since he was not entitled to a transportation allowance, the master of the ship withheld from the crew member's pay LSC's estimated cost for his return to the United States. This amount was the $1,000 the crew member refers to in his allegation. LSC's actual cost for his return ticket was $1,946. Based on our discussions with LSC and MSC officials, we also determined that LSC does not have access to Government Travel Requests and that none have been issued to it by MSC.

- - - -

As agreed with your Office, unless you publicly announce its contents earlier, we plan no further distribution of this fact sheet until 7 days from its date. At that time we will

B-226840

send copies to interested parties and make copies available to others upon request.

If you have any questions, please contact me at 275-6504.

Sincerely yours,

John Landicho
Senior Associate Director

(394256)

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QUESTIONS SUBMITTED BY THE HONORABLE WALTER B. JONES, CHAIRMAN, SUBCOMMITTEE ON MERCHANT MARINE TO VICE ADMIRAL WALTER T. PIOTTI, JR., COMMANDER, MILITARY SEALIFT COMMAND (DEPARTMENT OF THE NAVY); ALONG WITH ANSWERS FURNISHED BY THE DEPARTMENT OF THE NAVY, JANUARY 24, 1989

Chairman Jones: In the event that the number of liner companies declines even further -- with a further decline in dry-cargo ships, how does MSC plan to meet its peacetime and contingency cargo shipping requirements?

Admiral Piotti: Not withstanding the fact that the number of companies have declined, the capability of U.S. liner companies has significantly increased. From January 1970 to June 1988, the number of U.S. flag, privately owned cargo ships declined from 893 to 410, a decline of 54 percent. However, due to more productive ships having greater size, higher speed, and improved cargo handling capability, the carrying capacity actually increased by 28 percent (from 15.8 million deadweight tons to 20.2 deadweight tons.)

In 1970, the U.S. flag liner ships carried 11.8 million tons of U.S. oceanborne foreign trade, equating to 23.5 percent of the total of 50.4 million tons. In 1986, U.S. flag ships carried 14.3 million tons, a 21 percent increase over 1970. This unfortunately represented only a 19.9 percent market share of the total 71.8 million tons. This decreased market share of U.S. liner trade reflects the need for carriers to regain the market share once held.

Chairman Jones: Please discuss the MSC's position on the use of a stable cargo rate system based on the established tariff rates used for commercial shippers as the Commission on Merchant Marine and Defense recently recommended?

Admiral Piotti: The current system of procurement is mandated by the Armed Services Procurement Act, Title 10, U.S.C. 2301, as amended by the Competition in Contracting Act, Public Law 99-346. Carriers offer rates to MSC for the carriage of DOD cargo, on whatever trade routes they wish to serve, on a full and open competitive basis, and such rates reflect the conditions of the marketplace. The Commission's suggestion that these procurement policies are a cause of the maritime industry's problems, including the financial failure of U.S. flag operators, is unsupported. At a recent Federal Maritime Commission sponsored industry conference held in Long Beach, California, senior officials of major U.S. flag and foreign flag carriers, as well as academicians, blamed overtonnage on major routes, as encouraged by banks, shipyards, and foreign governments, for most of the industry's problems. The imbalance of trade was also cited as a major factor. Conspicuously absent during the conference was any mention by carrier officials that DOD procurement policies and practices were a cause of the industry's decline.

Furthermore, there is no evidence that the carrier's rate setting practices for DOD cargo are any different than those for commercial cargo. Since the passage of the Shipping Act of 1984, U.S. and foreign flag carriers reportedly negotiate rates for large volumes of cargo under "service contracts" with major shippers at favorable rate levels well below commercial tariff rates. Conference carriers, including U.S. flag operators, also exercise their right of independent action under Section 5(b)(8) of the Shipping Act of 1984 and individually reduce conference tariff rates to competitively obtain commercial cargoes. These reports are borne out by

Federal Maritime Commission studies conducted in conjunction with the Shipping Act of 1984, and reported at the industry conference referred to above. In reality, therefore, commercial tariff rates will reflect artificially high rates as more cargo is moved at lower rates under service contracts or independent action. Given that increasing numbers of tariff rates are becoming mere paper rates, the Commission's recommendation that DOD's rates should be based on commercial tariff with an agreed percentage reduction would place the Government at a cost disadvantage vis-a-vis commercial shippers. It would create a noncompetitive and artificial baseline for DOD rates resulting in a subsidizing of commercial cargo by DOD. Thus, establishment of MSC rates based on tariffs would result in DOD's paying rates substantially higher than those paid by commercial shippers and, we believe, would be contrary to the provisions of the 1904 Cargo Preference Act. In addition, and most important, a report by an independent research firm concluded that it is unlikely that an increase in revenues from the carriage of DOD cargo would increase the number of militarily useful ships in the commercial fleet since the types of ships we need are the least efficient commercially.

Chairman Jones: What are the MSC's views on providing direct subsidies to the U.S. maritime industry to foster greater commercial activity? Please discuss what ground rules need to be established and the potential costs involved?

Admiral Piotti: As indicated in the General Accounting Office (GAO) report of August 9, 1988, the Government is faced with two competing objectives: the requirement of competitive procurement to obtain services at the lowest possible cost and the need to maintain a mobilization base. Changes to the present procurement system would no doubt result in significant cost increases to the Government. GAO has indicated that such costs should be fully identified and disclosed. Thus, GAO recognized that such changes were tantamount to subsidies that should be consciously and deliberately revealed, debated, and if then found to be in the Government's best interest, authorized.

MSC recognizes that U.S. flag vessels cannot compete on an equal basis with foreign shipping companies because of higher costs inherent in U.S. flag shipping operations. Some form of subsidy may be necessary if we are to have a viable U.S. flag merchant marine. In the direct subsidy approach, costs can be identified, debated, and informed decisions made on that basis.

Chairman Jones: Given that commercial ship operators are concerned that the OMB Circular A-76 process is not providing them with a fair share of business, what suggestions does MSC have to address their concerns?

Admiral Piotti: I believe that commercial ship operators are receiving a fair share of MSC business. The intent of OMB Circular A-76 is to provide the Government with commercial-type services at the lowest cost by enhancing quality, productivity, and economy. In this connection, both the Government and private sector are expected to utilize and take full advantage of available costs savings inherent in their respective operations. Competitive procurement for these services has brought significant savings to the taxpayer. In January 1984, the Navy identified 30 MSC ships then operated with civil service crews as having potential

for commercial operation. Subsequently, several others (e.g. the hospital ships) have been identified for cost comparison. Since that time MSC has conducted A-76 efficiency studies on 24 ships operated with civil service-mariner crews. Twelve of those ships have subsequently been turned over to commercial contract operation, while 12 have remained as civil service operated ships. Sixteen ships are currently scheduled for study. Actual savings, plus aviodance of additional costs, totalling $115 million have been realized since FY85 as a result of these commercial activity studies. MSC's objective is to provide the most efficient operation, while at the same time giving the private sector full and open opportunity to compete for these services.

Additionally, 13 Maritime Prepositioning Ships, eight Fast Sealift Ships, and 10 Ocean Surveillance Ships (T-AGOS) have been placed under private industry contract operation since 1984 without competition for civil service operation, and two Aviation Logistic Support Ships (T-AVB) and 6 Crane Ships (T-ACS) have been identified for operation by the private sector. MSC currently contracts for an additional 13 dry cargo ships, 26 tankers, and eight other ships with private sector manning. Statistically, the current MSC fleet is 68% manned with contractor crews and 32% civil service manned. The civil service crewed ships include those providing fleet support to the combatant fleets which are not identified for A-76 study.

Chairman Jones: Please discuss the minimum-size merchant marine workforce that would be required to respond to full-scale mobilization requirements.

(a) How does the current workforce compare to these requirements?

(b) If too small, what are MSC's plans for rapid expansion of the workforce?

Admiral Piotti: Initial mobilization billet requirements for 1988 are based upon ship availability which currently consists of manning 25 Afloat Prepositioning ships, 25 Effective U.S. Controlled (EUSC) ships (which represents 20% of the available EUSC ships), 101 Government owned ships (includes Fast Sealift Ships (FSS), T-AVB ships, and Ready Reserve Force (RRF) ships), 47 MSC controlled ships, and 343 U.S. flag fleet ships. The available manpower pool to operate these ships and which is used as a baseline is 23,984. In 1994, the number of ships on which initial mobilization requirements are based is reduced to 490. The major reduction occurs in the U.S. flag fleet. Other categories, such as Government owned and MSC controlled ships increase. The Afloat Prepositioning and EUSC categories remain at 25 ships each.

Currently, the actively sailing, oceangoing merchant marine workforce consists of approximately 24,943 personnel. If 90% of the available workforce (21,587) mariners, were to report for the initial phase of mobilization during a contingency in 1988, there could be a minimal shortfall. However, depending on the assumptions used, there could be a projected shortfall of up to 4,782 mariners needed to sustain contingent operational requirements. This shortfall could increase to as many as 7,442 mariners in the 1994 timeframe.

Chairman Jones: How do you ensure that those who prepare MSC's proposals under OMB Circular A-76 are insulated from those who receive and evaluate commercial offers? Please discuss in terms of specific internal controls in place to protect the integrity of the process.

Admiral Piotti: The integrity of the A-76 process is governed by specific Navy instructions which implement policy concerning the Navy's Commercial Activities studies. MSC establishes two teams with separate individuals to conduct an A-76 review: a contract team and a Government proposal team.

The contract team receives and evaluates the commercial offers. These individuals are briefed about the importance of not disclosing the contents of the commercial offers and must sign nondisclosure statements. Commercial offers are maintained in a secure area, and only the technical proposals are provided to the evaluators. The technical proposals are kept separate from the cost proposals, and the contracting officer is the only individual who evaluates the cost proposals.

The Government team prepares the Most Efficient Organization (MEO), which is the Government's proposal for operation, and the Government cost estimates. Prior to receipt of commercial offers, the MEO is completed, and the cost estimate is certified by the Navy Audit Service. Both documents are given to the contracting officer in a sealed envelope. After the low, technically acceptable commercial offer is selected, the Government estimate is opened and compared with that commercial offer. During the review and evaluation process there is no interaction between the two teams.

All of the steps are taken pursuant to Navy instructions which require that all cost data from the Government and commercial offers remain separate throughout the process leading to the MSC recommendation and Chief of Naval Operations selection of the low offeror.

Chairman Jones: Please provide a listing of the ships that the MSC is responsible for operating and maintaining, including: each ship's name and hull number, type of mission, whether operated by the MSC or a commercial firm, whether restricted to Government operation, and the reason for the restriction.

Admiral Piotti: During FY89 MSC is responsible for the operation and maintenance of the following ships. Only those ships of the Naval Fleet Auxiliary Force which have the primary mission of underway replenishment in direct support of fleet operations are currently restricted to Government operation. The restriction is based on the operational requirement to carry out their primary mission with the combatant units of the Navy in all contingencies.

I. STRATEGIC SEALIFT

Dry Cargo Ships	Hull Number	Operator
MV AMERICAN EAGLE	T-AKR 2044	Automar I Corp.
USNS MERCURY	T-AKR 10	MSC
SS SANTA JUANA	T-AK 2041	Vessel Charters
SS SANTA ADELA	T-AK 2051	Vessel Charters
SS GREEN WAVE	T-AK 2050	Central Gulf Lns
MV GREEN RIDGE	---------	Central Gulf Lns
MV MAERSK CONSTELLATION	---------	Maersk Lines
SS ROVER	T-AK 1013	Central Gulf Ln
MV RAINBOW HOPE	---------	Rainbow Navigatn

Tankers

MS BRAVADO	----------	Sealift Incorp.
MS PAUL BUCK	T-AOT 1211	Ocean Prod Tnkrs
MS SAMUEL COBB	T-AOT 1212	Ocean Prod Tnkrs
MS GUS W. DARNELL	T-AOT 1210	Ocean Prod Tnkrs
MS LAWRENCE H. GIANELLA	T-AOT 1214	Ocean Prod Tnkrs
MS RICHARD G. MATTHIESEN	T-AOT 1213	Ocean Prod Tnkrs
MV FALCON CHAMPION	T-AOT 1209	Falcon Carriers
MV COURIER	T-AOT 1007	Ogden Bulk Trnspt
MV PATRIOT	T-AOT 1001	OMI Bulk Transpt
MV ROVER	T-AOT 1006	OMI Bulk Transpt
USNS SEALIFT ANTARCTIC	T-AOT 176	MTL
USNS SEALIFT ARABIAN SEA	T-AOT 169	MTL
USNS SEALIFT ARCTIC	T-AOT 175	MTL
USNS SEALIFT ATLANTIC	T-AOT 172	MTL
USNS SEALIFT CARIBBEAN	T-AOT 174	MTL
USNS SEALIFT INDIAN OCEAN	T-AOT 171	MTL
USNS SEALIFT MEDITERRANEAN	T-AOT 173	MTL
USNS SEALIFT CHINA SEA	T-AOT 170	MTL
MS RANGER	T-AOT 1002	Ogden Bulk Trnspt
SUSAN HANNAH/BARGE HANNA 4002	N/A	Hannah Marine
TUG SENECA/BARGE 225	N/A	Crowley
SS TEXACO NEW YORK	NEW	Texaco

Prepositioning Ships

SS GREEN HARBOUR	T-AK 2064	Central Gulf Lns
SS GREEN ISLAND	T-AK 1015	Central Gulf Lns
SS AMERICAN KESTREL	---------	Pacific Gulf Marine
SS AUSTRAL RAINBOW	---------	Farrell Lines
MV AMERICAN CORMORANT	T-AK 2062	Automar III Corp.
SS SANTA VICTORIA	T-AK 1010	Vessel Charters
MV ADVANTAGE	NEW	Red River Shippng
SS OVERSEAS ALICE	T-AOT 1203	Alice Tankships
SS OVERSEAS VIVIAN	T-AOT 1205	Vivian Tankships
SS OVERSEAS VALDEZ	T-AOT 1204	Valdez Tankships
USNS SEALIFT PACIFIC	T-AOT 168	MTL
MV NOBLE STAR	---------	----------

Maritime Prespositioning Ships

MV PFC JAMES ANDERSON, JR	T-AK 3002	Maersk Line
MV PFC WILLIAM B. BAUGH	T-AK 3001	Maersk Line
MV 1ST LT ALEX BONNYMAN	T-AK 3003	Maersk Line
MV 2ND LT JOHN P. BOBO	T-AK 3008	American Overseas Marine Corp.
MV SGT WILLIAM R. BUTTON	T-AK 3012	American Overseas Marine Corp.
MV PVT HARRY FISHER	T-AK 3004	Maersk Line
MV CPL LOUIS J. HAUGE, JR	T-AK 3000	Maersk Line
MV 1ST LT BALDOMERO LOPEZ	T-AK 3010	American Overseas Marine Corp.
MV 1ST LT JACK LUMMUS	T-AK 3011	American Overseas Marine Corp.
MV PFC DEWAYNE T. WILLIAMS	T-AK 3009	American Overseas Marine Corp.
SS SGT MATEJ KOCAK	T-AK 3005	Waterman SS
SS PFC EUGENE A. OBREGON	T-AK 3006	Waterman SS
SS MAJ STEPHEN W. PLESS	T-AK 3007	Waterman SS

II. STRATEGIC SEALIFT RESERVE

Fast Sealift Ships

USNS ALGOL	T-AKR 287	IMC
USNS ALTAIR	T-AKR 251	Bay Tankers
USNS ANTARES	T-AKR 172	IMC
USNS BELLATRIX	T-AKR 288	IMC
USNS CAPELLA	T-AKR 293	IMC
USNS DENEBOLA	T-AKR 289	Bay Tankers
USNS REGULUS	T-AKR 292	Bay Tankers
USNS POLLUX	T-AKR 290	Bay Tankers

Hospital Ships

USNS COMFORT	T-AH 20	MSC
USNS MERCY	T-AH 19	MSC

Aviation Logistics Support Ships

USNS CURTISS	T-AVB 4	Interocean Mgmt
USNS WRIGHT	T-AVB 3	Interocean Mgmt

** Ready Reserve Force Ships -- These ships are maintained by the Maritime Administration and come under the cognizance of the Military Sealift Command for operational purposes.

Dry Cargo

SS KEYSTONE STATE	ACS 1	MarAd
SS GEM STATE	ACS 2	Takoma Boat Bldg.
SS GRAND CANYON STATE	ACS 3	Port of Portland
SS GOPHER STATE	ACS 4	Navy/Chetham Annx
SS FLICKERTAIL STATE	ACS 5	MarAd
SS CORNHUSKER STATE	ACS 6	MarAd
SS WASHINGTON	AK 5020	American Foreign Shipping
SS MAINE	AK 5021	American Foreign Shipping
SS CAPE AVINOF	AK 5013	American Overseas Marine
SS ADVENTURER	AK 5005	Marine Carriers
SS AIDE	AK 5006	Newport Offshore
SS AGENT	AK 5015	Marine Carriers
SS AMBASSADOR	AK 5007	Marine Carriers
SS BANNER	AK 5008	Marine Carriers
SS CAPE ANN	AK 5009	American Overseas Marine
SS CAPE ALEXANDER	AK 5010	Marine Carriers
SS CAPE ARCHWAY	AK 5011	Marine Carriers
SS CAPE ALAVA	AK 5012	Marine Carriers
SS CAPE ARCHWAY	AK 5011	Marine Carriers
SS CAPE ALAVA	AK 5012	Marine Carriers
SS CAPE CARTHAGE	AK 5042	American Overseas Marine Corp.
SS LAKE	AK 5016	American Overseas Marine Corp.
SS PRIDE	AK 5017	American Overseas Marine Corp.
SS SCAN	AK 5018	American Overseas Marine Corp.
SS CAPE JOHNSON	--------	MarAd
SS COURIER	AK 5019	Marine Carriers
SS CAPE CANAVERAL	AK 5040	American Overseas Marine Corp.
SS CAPE CANSO	AK 5037	Marine Carriers
SS CAPE CATOCHE	AK 5043	American Overseas Marine Corp.

SS CAPE LOBOS	--------	MarAd
MV CAPE LAMBERT	--------	MarAd
SS CAPE NOME	AK 1014	MarAd
EX-USNS SOUTHERN CROSS	AK 285	American Overseas Marine Corp.
SS CAPE JUBY	--------	MarAd
SS CAPE COD	AK 5041	Ogden Marine
SS GULF BANKER	AK 5044	All Marine Svc
SS GULF FARMER	AK 5045	All Marine Svc
SS GULF MERCHANT	AK 5046	All Marine Svc
SS GULF TRADER	AK 2036	All Marine Svc
SS CAPE MENDOCINO	AK 5064	Ogden Marine
SS PIONEER COMMANDER	AK 2016	PWC Engineering
SS PIONEER CRUSADER	AK 2019	PWC Engineering
SS DEL VALLE	AK 5050	PWC Engineering
SS DEL MONTE	AK 5049	PWC Engineering
SS DEL VIENTO	AK 5026	PWC Engineering
SS SANTA ANA	AK 5022	Ogden Marine
SS GULF SHIPPER	AK 2035	All Marine Svc
SS CAPE CHALMERS	AK 5036	Ogden Marine
SS CAPE CHARLES	AK 5038	Ogden Marine
SS CAPE CLEAR	AK 5039	Ogden Marine
SS PIONEER CONTRACTOR	AK 2018	PWC Engineering
SS BUYER	AK 2033	Mobile Dock
SS CALIFORNIA	AK 5029	Navy
EX-USNS NORTHERN LIGHT	AK 284	Amer. President
SS CAPE GIBSON	-------	Amer. President
SS CAPE GIRARDEAU	AK 2039	MarAd
SS CAPE MAY	AKR 5063	Ogden Marine
SS CAPE FLORIDA	AKR 5071	IMC
SS CAPE DOUGLAS	AKR 5052	MTL
GTS ADMIRAL WM. M. CALLAGHAN	AKR 1001	Marine Carriers
SS CAPE DOMINGO	AKR 5053	MTL
SS CAPE DECISION	AKR 5054	MTL
SS CAPE HENRY	AKR 5067	Interocean Mgmt.
SS CAPE HUDSON	AKR 5066	Interocean Mgmt.
SS CAPE MOHICAN	AKR 5065	Ogden Marine
SS CAPE DIAMOND	AKR 5055	MTL
SS CAPE CATAWBA	AKR 5074	MarAd
SS CAPE FAREWELL	AKR 5073	IMC
SS CAPE FLATTERY	AKR 5070	IMC
SS CAPE INSCRIPTION	AKR 5076	Violet Dock
SS AUSTRAL LIGHTNING	AKR 5061	Interocean Mgmt.
SS JUPITER	AKR 11	Amer. President
EX-USNS COMET	AKR 7	Amer. President
MV CAPE HORN	AKR 5068	Interocean Mgmt.
SS CAPE BRETON	AKR 5056	Amer. President
SS CAPE BLANCO	AKR 5060	Amer. President
EX-USNS METEOR	AKR 9	Interocean Mgmt.
SS CAPE BOVER	AKR 5057	Amer. President
SS CAPE BON	AKR 5059	Interocean Mgmt.
SS CAPE ISABEL	AKR 5062	Amer. President
SS CAPE BORDA	AKR 5058	Amer. President
SS CAPE EDMONT	AKR 5069	Interocean Mgmt.
SS CAPE DUCATO	AKR 5051	Interocean Mgmt.

Troop Ship

TV PATRIOT STATE	T-AP 1000	IOM

Tankers

EX-USNS AMERICAN EXPLORER	T-AOT 165	American Foreign Shipping
EX-USNS POTOMAC	T-AOT 181	American Foreign Shipping
SS MISSION BUENAVENTURA	T-AOT 1012	MarAd
EX-USNS SHOSHONE	T-AOT 151	Amer. President
EX-USNS NODAWAY	T-AOG 78	Crowley
EX-USNS ALATNA	T-AOG 81	Crowley
EX-USNS CHATTAHOOCHEE	T-AOG 82	Crowley
SS MISSION CAPISTRANO	---------	MarAd
SS AMERICAN OSPREY	---------	American Foreign Shipping

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III. MISCELLANEOUS SERVICE SUPPORT

Tankers

MV OVERSEAS HARRIET	--------	Ocean Bulk Ships

IV. SPECIAL MISSION SUPPORT

Missile Range Instumentation Ships

USNS RANGE SENTINEL	T-AGM 22	MSC
USNS OBSERVATION ISLAND	T-AGM 23	MSC
USNS REDSTONE	T-AGM 20	MSC
USNS POINT LOMA	T-AGDS 2	MSC

Oceanographic Ships

USNS BARTLETT	T-AGOR 13	Lavino Shipping
USNS DE STEIGUER	T-AGOR 12	Lavino Shipping
USNS HAYES	T-AGOR 16	Lavino Shipping
USNS LYNCH	T-AGOR 7	Lavino Shipping

Surveying Ships

USNS SILAS BENT	T-AGS 26	Lavino Shipping
USNS H.H. HESS	T-AGS 38	Lavino Shipping
USNS CHAUVENET	T-AGS 29	Lavino Shipping
USNS DUTTON	T-AGS 22	Lavino Shipping
UNSN HARKNESS	T-AGS 32	Lavino Shipping
USNS KANE	T-AGS 27	Lavino Shipping
USNS WILKES	T-AGS 33	Lavino Shipping
USNS WYMAN	T-AGS 34	Lavino Shipping

Navigation Test Support Ship

USNS VANGUARD	T-AG 194	MSC

Undersea Cable Transport Ship

USNS FURMAN	T-AK 280	MSC

Cable Repairing Ships

USNS ALBERT J. MYER	T-ARC 6	MSC
USNS NEPTUNE	T-ARC 2	MSC
USNS ZEUS	T-ARC 7	MSC

Undersea Surveillance Ship

USNS MIZAR	T-AGOR 11	MSC

V. NAVAL FLEET AUXILIARY FORCE

Ammunition Ship

USNS KILAUEA	T-AE 26	MSC

Fleet Stores Ship

USNS RIGEL	T-AF 58	MSC

Combat Stores Ships

USNS SIRIUS	T-AFS 8	MSC
USNS SATURN	T-AFS 10	MSC
USNS SPICA	T-AFS 9	MSC

Fleet Oilers

USNS HASSAYAMPA	T-AO 145	MSC
USNS KAWISHIWI	T-AO 146	MSC
USNS MISPILLION	T-AO 105	MSC
USNS MISSISSINEWA	T-AO 144	MSC
USNS NAVASOTA	T-AO 106	MSC
USNS NEOSHO	T-AO 143	MSC
USNS PASSUMSIC	T-AO 107	MSC
USNS PAWCATUCK	T-AO 108	MSC
USNS PONCHATOULA	T-AO 148	MSC
USNS TRUCKEE	T-AO 147	MSC
USNS WACCAMAW	T-AO 109	MSC
USNS KAISER	T-AO 187	MSC
USNS HUMPHREYS	T-AO 188	MSC
USNS LENTHALL	T-AO 189	MSC
USNS HIGGINS	T-AO 190	MSC
USNS DIEHL	T-AO 193	MSC
USNS GRUMMAN	T-AO 195	*
USNS ISHERWOOD	T-AO 191	*

* Delivery scheduled for the fourth quarter of FY89.

Fleet Ocean Tugs

USNS APACHE	T-ATF 172	MSC
USNS CATAWBA	T-ATF 168	MSC
USNS MOHAWK	T-AFT 170	MSC
USNS NAVAJO	T-AFT 169	MSC
USNS POWHATAN	T-AFT 166	MSC
USNS SIOUX	T-AFT 171	MSC
USNS NARRAGANSETT	T-AFT 167	MSC

Fleet Ballistic Missile Ships

USNS MARSHFIELD	T-AK 282	MSC
USNS VEGA	T-AK 286	MSC

Surveillance Ships

USNS STALWART	T-AGOS 1	Sea Mobility
USNS CONTENDER	T-AGOS 2	Sea Mobility
USNS VINDICATOR	T-AGOS 3	Sea Mobility
USNS TRIUMPH	T-AGOS 4	Sea Mobility
USNS ASSURANCE	T-AGOS 5	Sea Mobility
USNS PERSISTENT	T-AGOS 6	Sea Mobility
USNS INDOMINITABLE	T-AGOS 7	Sea Mobility
USNS PREVAIL	T-AGOS 8	Sea Mobility
USNS ASSERTIVE	T-AGOS 9	Sea Mobility
USNS INVINCIBLE	T-AGOS 10	Sea Mobility
USNS ADVENTUROUS	T-AGOS 13	MSC
USNS WORTHY	T-AGOS 14	*
USNS TITAN	T-AGOS 15	*
USNS AUDACIOUS	T-AGOS 11	*

* Delivery scheduled for the fourth quarter of FY89.

Fleet Auxilary Time Charter

GTMO TUG	----------	----------

Chairman Jones: (a) If these ships that are not restricted to Government operation were commercially operated, what would be the effect on MSC's civil service mariner workforce? On the total costs of their operation and maintenance? (b) What are the annual costs to operate and maintain these ships, including contract costs, MSC costs, and the costs of operating MSC's Marine Placement and Receiving Branches?

Admiral Piotti: With respect to the ships not restricted to Government operation, which are civil service manned and which have not already been the subject of a cost comparison under OMB circular A-76, the civil service workforce would lose 233 positions if the vessels were turned over to commercial operation. These ships consist of 7 fleet ocean tugs, 1 dry cargo ship, and 1 oceanographic ship. In FY87 the annual costs for operating these MSC ships was $30.7 million. This does not include costs for the USNS HAYES, the oceanographic ship, which has been inactive for several years. The ship is being converted to a Mobile Noise Barge (MONOB) and is scheduled to be back in service in July 1990.

QUESTIONS SUBMITTED BY THE HONORABLE NORMAN F. LENT, RANKING MINORITY MEMBER, SUBCOMMITTEE ON MERCHANT MARINE TO VICE ADMIRAL WALTER T. PIOTTI, JR., COMMANDER, MILITARY SEALIFT COMMAND (DEPARTMENT OF THE NAVY); ALONG WITH ANSWERS FURNISHED BY THE DEPARTMENT OF THE NAVY, JANUARY 24, 1989

Mr. Lent: How does MSC procurement policies establish preferences for U.S. flag carriers under the Cargo Preference Act?

Admiral Piotti: In accordance with the 1904 Cargo Preference Act, all MSC solicitations for ocean transportation of DOD cargo give preference for U.S. flag carriers, if available. In FY87 more than 97 percent of dry cargo and more than 92 percent of petroleum products shipped by the Department of Defense moved in U.S. flag ships. The Commander, MSC personally approves all use of foreign flag ships for the carriage of DOD cargo moving in the Defense Transportation System. Such approval is given only when there is no U.S. flag vessel available to meet cargo delivery requirements.

Mr. Lent: How does the MSC selection process consider differences in schedule, configuration, size, and capacity when evaluating offers?

Admiral Piotti: With respect to solicitations for liner service, MSC does not consider such differences when awarding shipping and container agreements; all liner operators who submit technically acceptable offers are awarded contracts. Considerations such as schedule and vessel configuration are taken into account at the time of booking. Cargo is booked to the low cost carrier who offers acceptable space and a schedule meeting the delivery requirements of the cargo.

Solicitations for time chartered ships specify the Government's minimum needs, which may include specific configurations, speed, size and capacity. Offers of ships whose characteristics meet those minimum needs and are otherwise technically acceptable are compared, and award is made on the basis of lowest cost to the government.

Mr. Lent: Given the generally depressed nature of the U.S. maritime industry, isn't it true that heavy competition can be expected naturally to hold down prices to a reasonable level?

Admiral Piotti: MSC is the single largest customer of the U.S. Merchant Marine. Under the Armed Services Procurement Act, as amended by the Competition in Contracting Act, MSC is required to obtain all goods and services through full and open competition, with very limited exception. Historically, regardless of the state of the industry, MSC has employed competitive procurement practices to acquire ocean transportation services at prices which reflect the marketplace.

MSC is affected by the same market forces as any other ocean shipper. Each shipper's rates for cargo on a particular route are determined by the combination of currency, exports, and operating cost fluctuations, together with competition, changes in capacity, and demand. Competitive procurement is our federal government policy and is the basis for all government purchasing. Competition has brought significant savings to the taxpayer and sharpened the cost effective consciousness of contractors. As with other Government agencies, MSC is a steward of the taxpayer's money and has a prime obligation to expend the money in the most cost effective manner.

Mr. Lent: Are MSC contracting officials required to comply with procurement directives and interpretations issued by the Secretary of Defense?

Admiral Piotti: Yes. Current procurement practices are dictated by the Armed Services Procurement Act, as amended by the Competition in Contracting Act, and as implemented by the Federal Acquisition Regulation. Therefore, the Military Sealift Command, as the single manager for sealift for the Department of Defense, acquires ocean and intermodal transportation services at rates competitively offered by ocean carriers in keeping with these laws and regulations.

Mr. Lent: What is MSC's policy with respect to issuing solicitations for overseas transportation?

Admiral Piotti: Solicitations issued by MSC contracting offices overseas seek to achieve full and open competition and give preference for U.S. flag carriers when available.

Mr. Lent: How much notice is given to MSC of the need for overseas transportation of supplies?

Admiral Piotti: Department of Defense agencies provide their overseas shipping requirements to MSC six months before the start of a new fiscal year. These requirements are updated monthly for the succeeding three months. Unscheduled requirements are added to those previously forecasted as need dictates.

Mr. Lent: Under what circumstances are solicitations for overseas transportation issued from U.S. contracting offices? Issued from foreign contracting offices?

Admiral Piotti: Most solicitations for liner agreements, long term bareboat, time charters, and voyage charters are issued and awarded from MSC Headquarters. Solicitations for movements not covered by solicitations issued by MSC Headquarters are issued by the MSC area command (in the U.S. and overseas) where the movement originates.

Mr. Lent: Which senior MSC personnel (military and civilian) have received monetary awards in the past three years in recognition of their contributions to reduction of the procurement budget and of significant savings at MSC?

Admiral Piotti: Pursuant to Civil Service Regulations as implemented by Navy instructions, monetary awards are provided for overall performance which includes a variety of accomplishments. During FY 1987, more than 100 senior and mid-level managers received performance awards.

Mr. Lent: How many recommendations for a small business set-aside from the MSC small business specialists have been rejected by senior MSC personnel during the past two years? Why?

Admiral Piotti: No recommendation by MSC's Small Business Specialist to set-aside a MSC procurement has been rejected by senior MSC personnel within the past two years.

QUESTIONS SUBMITTED BY THE HONORABLE HELEN D. BENTLEY, MEMBER, SUPCOMMITTEE ON MERCHANT MARINE TO VICE ADMIRAL WALTER T. PIOTTI, JR., COMMANDER, MILITARY SEALIFT COMMAND (DEPARTMENT OF THE NAVY); ALONG WITH ANSWERS FURNISHED BY THE DEPARTMENT OF THE NAVY, JANUARY 24, 1989

Mrs. Bentley: The Commission on Merchant Marine and Defense has criticized the Military Sealift Command's procurement practices because of the adverse effect they have on commercial operators and on the viability of the American Merchant Marine. In particular, the Commission noted that "ship operators have been driven to submit bids so low as to be destructive." What measures have you taken to ensure that your procurement practices do not have these destructive effects?

Admiral Piotti: We do not believe that there is any objective evidence to substantiate the assertion that MSC's procurement system has driven carriers to submit "destructive" bids.

The Harbridge House report states that the rates paid by the Department of Defense (DOD) for liner services appears to be consistent with negotiated commercial rates paid by large shippers using service contracts permitted by the 1984 Shipping Act. Additionally, the report indicated that the adoption of a system that required DOD to pay tariff rates would result in substantially higher costs. The report further indicated that on some trade routes tariffs appear to be little more than "paper routes" with virtually all traffic moving via lower priced service contracts. Therefore, establishment of MSC rates based on filed tariffs would result in DOD paying rates higher than those paid by commercial shippers. Harbridge House also concluded that it is unlikely that an increase in U.S. liner revenues from the carriage of DOD cargo would increase the number of militarily useful ships in the commercial fleet. The types of ships which DOD will want most in an emergency, such as breakbulk ships, are the least efficient commercial ships. Conversely, the most efficient commercial ships are large non self- sustaining container ships, which are the least militarily useful.

In order to enhance the mobility base, MSC has since 1971 included a clause in its solicitations which limits the amount of DOD cargo which can be shipped via any one carrier on certain major routes. A clause providing for adjustment rates to reflect fluctuations in bunker fuel prices was included from 1971-1987. It was deleted at the request of the carriers.

Ensuring that all U.S. flag ships have an equal and unencumbered access to Government impelled cargoes is a formidable aid that the Government must employ to maintain a viable U.S. flag merchant fleet to meet our defense needs.

Mrs. Bentley: The Military Sealift Command awards cargo to merchant vessel operators based on their bid prices. The operator with the lowest bid is given the first opportunity to carry the cargo. What measures have you taken to ensure that the emphasis on minimizing the short-term costs does not threaten the long-term viability of the American merchant marine?

Admiral Piotti: MSC's procurement policy is in conformance with the congressional mandate in the Competition in Contracting Act to procure services using full and open competition. MSC assumes that rates offered by each U.S. flag carrier for carriage of DOD cargo reflect its business judgment as to what is in its best interest to ensure its long-term viability. The maximum percentage of cargo limitation clause used by MSC on specific routes has resulted in more than one carrier carrying some portion of the available DOD cargo. While I share your concern for the state of the American Merchant Marine, I know of no objective evidence to substantiate the assertion that MSC's procurement system has had a negative impact on U.S. flag carriers.

Mrs. Bentley: Does your procurement system consider in any way the long-term detrimental impact that the emphasis on short-term costs savings may be having on the merchant marine?

Admiral Piotti: MSC's procurement system is in compliance with all requirements of the Armed Services Procurement Act, as amended, the Federal Acquisition Regulation, and other DOD procurement regulations, all of which apply to all DOD procurements. There is no objective evidence to substantiate the assertion that MSC's procurement system has had a negative impact on U.S. flag carriers.

Strategic sealift contingency programs were initiated by the U.S. Navy as stopgap measures to provide for national security during the decline of the U.S. flag merchant marine assets. These programs are not the final nor best solution. A more desirable solution(s) would be a healthy and competitive U.S. merchant marine capable of meeting the nation's economic and military maritime requirements at all times, but particularly during national emergencies.

Mrs. Bentley: Do any of your current procurement practices, which focus on minimizing short terms costs, help ensure the future viability of the merchant marine?

Admiral Piotti: The Military Sealift Command is a strong advocate for a viable merchant marine but "the" lead advocate, of course, is the Maritime Administration (MarAd)/Department of Transportation pursuant to its statutory authority under the Merchant Marine Act of 1936. We work very closely with MarAd and each year have testified, before your committee and the Senate, in support of MarAd's budget for direct aid to the industry. The Department of Defense provides the U.S. liner industry with the largest and most stable supply of cargo in trades otherwise characterized by wide fluctuations in volume, and which, MSC believes, is transported at rates that are fully compensatory. I must emphasize that there is no objective evidence the substantiate the assertion that MSC's procurement system has a negative impact on the maritime industry.

Mrs. Bentley: Admiral Piotti, you have been quoted as saying that the Military Sealift Command is "not the advocacy agency for the merchant marine." What role, if any, do you believe the MSC should play in maintaining and strengthening our merchant marine?

Admiral Piotti: Pursuant to the 1904 Cargo Preference Act all Military Sealift Command awards are for U.S. flag, U.S. citizen crewed transportation, when available. The congressional intent was to provide employment for U.S. flag vessels and generate a larger U.S. flag fleet for wartime purposes. As the single manager operating agency for sealift services within DOD, MSC's primary role vis-a-vis the American Merchant Marine is in administering the 1904 Cargo Preference Act with respect to cargo moving in the Defense Transportation System.

The Department of Defense and the U.S. Navy have made significant contributions to the vitality of the American Merchant Marine through its shipbuilding, conversion, and repair programs. The heavy marine industrial base of the United States, both publicly and privately owned, has executed an annual shipbuilding program for the U.S. Navy that for the last six years has averaged $11.9 billion per year, along with an annual modernization program of $1.2 billion for an annual repair and maintenance program of $3.5 billion for a total of well over $16 billion annually. All Navy shipbuilding and more than 30 percent of the repair and modernization are preformed in the private sector. Thus the private sector was the beneficiary of 81 percent of the Navy's total for shipbuilding, repair, and modernization, amounting to over $12 billion annually.

The maritime industry also benefits from Navy sealift operations. During the fiscal years 1982-1989, the Military Sealift Command will have spent over $5 billion for charter and contract-operated ships, such as Maritime Prepositioning Ships, Afloat Prepositioning Ships, Fast Sealift Ships, as well as the Ready Reserve Force; another $4.2 billion for shipping agreement contracts for breakbulk and container services and for berth term shipments. An additional $2.6 billion will be spent for the procurement of Sealift Enhancement Features and other amphibious equipment and for the operation and maintenance of contingency sealift ships. This adds to a total of approximately $12 billion over the FY 1982-1989 period for services rendered by the U.S. maritime industry.

MSC has played and will continue to play a major role in focusing the Department of Defense's reliance on the American Merchant Marine in implementing national strategy.

Mrs. Bentley: Does the Military Sealift Command currently accept bids from, or award charters to, operators that are foreign-owned, such as Maersk?

Admiral Piotti: All DOD requirements are met pursuant to the 1904 Cargo Preference Act which provides for the transportation of DOD cargo on vessels under U.S. flag registry and crewed by U.S. citizens. MSC has entered into various time charters for foreign built, previously foreign-flag ships which have been brought under U.S. flag in compliance with all vessel documentation laws and regulations

Mrs. Bentley: Do awards to foreign interests help to maintain or strengthen the American Merchant Marine?

Admiral Piotti: Yes. The Government should be flexible and encourage participation by those with private capital, foresight and new ideas; which will result in more ships being brought in under U.S. flag, employing U.S. crews, and generating work (re-flagging and maintenance) for U.S. shipyards.

Mrs. Bentley: Bidders that receive awards under MSC contracts are under no binding obligation to initiate service. For example, Apex Marine, Inc. -- which won the right to carry up to 75 percent of the military cargo between the East Coast and Europe during the six-month period beginning April 1, 1988--simply declined to begin service. Do you believe that this practice is fair to the other, more responsible bidders?

Admiral Piotti: Common-carrier type berth-line services permit carriers to enter or leave trade routes at their own discretion. This is a normal commercial practice. Additionally, trade route flexibility is a cornerstone of the various subsidy reform legislation proposed by Congress, (i.e., to give the U.S. carriers the ability to chose between business/trade opportunities.) If service is not commenced within the time specified in the contract, MSC cancels the carrier's rates. The Government is in no worse position than if the carrier had not offered rates at all.

In the Apex case, the owner of these U.S. flag vessels decided to employ the vessels elsewhere. This decision allowed the other U.S. carriers to get the benefit of all the cargo. The Government did not suffer any damages.

Mrs. Bentley: Why doesn't the Military Sealift Command have a prescreening process that will weed out carriers that are unable or unwilling to initiate service?

Admiral Piotti: MSC follows the FAR requirement that the Contracting Officer determine that a contractor is responsible before making an award.

Mr. Bentley: Has any firm which failed to initiate service after being awarded an MSC contract been subjected to any sanctions?

Admiral Piotti: When a contract has been awarded and the Government sustains damages or higher costs because of a firm's failure to initiate service, penalties have been assessed in accordance with the Federal Acquisition Regulation.

Mrs. Bentley: Does the MSC have a policy stating lead time required for it to arrange transport of preference cargo in order to encourage and promote competition among U.S. flag carriers for contract awards?

Admiral Piotti: The Competition in Contracting Act requires that transportation requirements be synopsized in the Commerce Business Daily in order to promote full and open competition among U.S. carriers. MSC complies with this requirement. Competition is maximized by informing all owners and brokers of requirements. This accomplished through an extensive mailing list; both electronic methods and regular postal service is used.

Mrs. Bentley: Does every RFP or RFQ issued by the MSC state preference for U.S.-flag carriers?

Admiral Piotti: Yes, with respect to solicitations for carriage of DOD cargo. MSC also issues RFP's for transportation of cargo for the Department of Energy's (DOE) Strategic Petroleum Reserve Program (SPR). As a non-DOD agency, DOE cargo is governed by Section 901(b) of the Merchant Marine Act of 1936, and not the 1904 Cargo Preference Act.

Mrs. Bentley: How does the MSC insure its market studies are completely comprehensive for a particular cargo offering? To what extent does the MSC encourage and use input from U.S.-flag operators in constructing offers?

Admiral Piotti: MSC's solicitations are sent to a complete list of U.S. flag owner/operators and shipping brokers. MSC frequently holds both pre-solicitation conferences and pre-proposal conferences, which provide a forum for a free exchange of information between the carriers and MSC with respect to the particular solicitation. In addition, MSC uses various information from U.S. flag operators, including assets and availability schedules, to structure the RFP in order to promote full and open competition while meeting the Government's minimum needs.

Mrs. Bentley: Does the MSC maintain a formal list of all present or potential U.S.-flag vessel operators, owners/operators, and/or ship brokers? Is this used worldwide?

Admiral Piotti: MSC maintains a formal bidders list of all present U.S. flag vessel operators, owner/operators, and/or ship brokers. MSC area commands maintain their own bidders lists.

Mrs. Bentley: What steps are taken to insure offerors for MSC contracts are certified American-flag ships with American crews?

Admiral Piotti: MSC relies upon the contractor's certification that its vessel is documented under U.S. flag, which entails compliance with laws and regulations administered by the U.S. Coast Guard. All RFPs for time charters and vessel operating contracts require 100 percent of crews to be U.S. citizens.

Mrs. Bentley: Explain why an offer can be cancelled because of "lack of adequate competition." What happens to the need or mission in this case?

Admiral Piotti: I am not aware of a specific case where this has occurred. As a theoretical matter, a lack of competition can lead to unfair and unreasonable rates. If only one offer is received, the FAR provides a mechanism for awarding a contract based on certified cost data and an audit by the Defense Contract Audit Agency (DCAA). If no offer is received, the situation would have to be evaluated under the particular circumstances. MSC would of course endeavor to meet the shipper service needs or mission by all available means subject to applicable laws and regulations.

Mrs. Bentley: Does the MSC attempt to place cargo offerings on MSC-owned or -chartered vessels first or after a general offer to U.S. flag owners?

Admiral Piotti: MSC's dry cargo and tanker fleet is composed of privately owned components of the U.S. merchant marine. Furthermore, all Government owned dry and liquid cargo ships have been placed in the Ready Reserve Force. The MSC chartered force is sized to meet requirements where there is no existing scheduled commercial service. Where there is a scheduled commercial service, the offerings are made and cargo is booked to the commercial operator. In FY87 more than 97 percent of dry cargo and more than 92 percent of petroleum products shipped by the Department of Defense moved in U.S. flag ships.

Mrs. Bentley: Under what circumstances does the MSC allow deviation from U.S.-flag preferential carriage to meet priorities/required delivery dates?

Admiral Piotti: The Commander, MSC personally approves all use of foreign flag ships for the carriage of DOD cargo moving in the Defense Transportation System. Such approval is given <u>only</u> when there is no U.S. flag vessel available to meet cargo delivery requirements.